



Spring 2006

Reforming the Branch Profits Tax to Advance Neutrality

Fred B. Brown

University of Baltimore School of Law, fbrown@ubalt.edu

Follow this and additional works at: http://scholarworks.law.ubalt.edu/all_fac



Part of the [Taxation-Transnational Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Reforming the Branch Profits Tax to Advance Neutrality, 25 Va. Tax Rev. 1219-1294 (2006)

This Article is brought to you for free and open access by the Faculty Scholarship at ScholarWorks@University of Baltimore School of Law. It has been accepted for inclusion in All Faculty Scholarship by an authorized administrator of ScholarWorks@University of Baltimore School of Law. For more information, please contact snolan@ubalt.edu.

REFORMING THE BRANCH PROFITS TAX TO ADVANCE NEUTRALITY

*Fred B. Brown**

TABLE OF CONTENTS

I.	INTRODUCTION.....	1220
II.	THE BRANCH PROFITS TAX AND ITS POLICY GOALS	1224
III.	THE BRANCH PROFITS TAX VERSUS THE DIVIDEND TAX ..	1229
	<i>A. Imputed Liabilities and the Automatic Nature of the Branch Profits Tax.....</i>	<i>1229</i>
	<i>B. Greater Flexibility of U.S. Subsidiaries in Retaining Earnings.....</i>	<i>1237</i>
	<i>C. Resulting Differences in the Imposition of Second-Level Taxes</i>	<i>1248</i>
IV.	MODIFYING THE BRANCH PROFITS TAX TO MAKE IT MORE EQUIVALENT TO THE DIVIDEND TAX	1252
	<i>A. Overview</i>	<i>1252</i>
	<i>B. Eliminating the Recapture Rule Contained in the Election to Reduce U.S. Liabilities</i>	<i>1254</i>
	1. Promoting Neutrality.....	1254
	2. Potential Conflict with the Policies Supporting the Fungibility Approach for Imputing Liabilities	1261
	<i>C. Removing the U.S. Booked Liability Limitation Under the Election to Reduce U.S. Liabilities</i>	<i>1264</i>
	1. Promoting Neutrality.....	1264
	2. Potential Policy Conflicts.....	1269
	<i>D. Providing an Election to Treat Assets as Effectively Connected</i>	<i>1270</i>
	1. Promoting Neutrality.....	1270
	2. Potential Policy Conflicts.....	1279

a. <i>Policies Underlying the Effectively Connected Income Rules</i>	1279
b. <i>Other Policies</i>	1282
E. <i>Election to Treat Assets as Effectively Connected with Changes to the Accumulated Earnings Tax</i>	1284
1. Possible Change in the Application of the Accumulated Earnings Tax to U.S. Subsidiaries	1284
2. Promoting Neutrality.....	1286
3. Potential Policy Conflicts.....	1292
V. CONCLUSION	1293

I. INTRODUCTION

In several respects, the U.S. tax system strives for neutral taxation. Neutrality is often concerned with similarly taxing different types of income that are economically equivalent.¹ For example, the Internal Revenue Code (Code) taxes interest income in the form of original issue discount prior to its receipt, regardless of whether the taxpayer uses the accrual or cash method,² because the instrument can be viewed as economically equivalent to earning interest on a bank account from which there are no withdrawals.³ There is also the view that the law should be neutral in taxing different forms of conducting business, so that business, rather than tax, considerations determine the form of business operations.⁴ While the double taxation of C

* Associate Professor of Law and Director of the Graduate Tax Program, University of Baltimore School of Law; B.S. with high honors 1982, Rutgers University; J.D. summa cum laude 1985, Georgetown University; LL.M. 1986, New York University. I thank Walter Schwidetzky for reviewing and providing helpful comments on a draft of this article. Any errors are solely the responsibility of the author.

¹ See, e.g., Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 727, 803-04 (1992) (proposing the taxation of certain investment assets by imposing a minimum rate of return in order to tax investment assets more equally); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 336 (1992) (proposing a uniform framework to develop rules for consistent treatment of financial instruments).

² See I.R.C. § 1272.

³ See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 729 (5th ed. 2005).

⁴ See Fred B. Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, 49 TAX L. REV. 133, 193 (1993).

corporations⁵ is inconsistent with this view,⁶ the treatment of S corporations⁷ and provisions aimed at equalizing the taxation of branches and subsidiaries in the cross-border context⁸ promote tax neutrality with respect to the form of conducting business.⁹

The branch profits tax¹⁰ is an example of a provision directed at achieving this latter type of neutrality. Enacted in 1986,¹¹ the purpose of the branch profits tax is to bring about more similar tax treatment of foreign corporations operating in the United States through U.S. branches and U.S. subsidiaries.¹² The branch profits tax attempts to promote neutrality by subjecting the U.S. branch earnings of a foreign corporation to a second level of U.S. tax upon the deemed remittance of the earnings outside of the U.S. branch.¹³ This is to approximate the second-level tax that occurs in the subsidiary setting when a U.S. subsidiary pays dividends to its foreign parent.¹⁴

Unlike the dividend tax in the subsidiary setting, however, the branch profits tax can apply even when all of a foreign corporation's U.S. earnings are retained for use in the operations of the U.S.

⁵ See I.R.C. §§ 301 *et seq.*

⁶ See generally DEPT. OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 3-5 (1992).

⁷ See I.R.C. §§ 1361-1379.

⁸ See I.R.C. §§ 902, 904(d).

⁹ See *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 135, 140 (1989) (pointing out that the legislative history of section 902 reflects an intent to equalize treatment of U.S. corporations that operate through foreign subsidiaries and those that operate through foreign branches); STAFF OF THE J. COMM. ON TAX'N, 100TH CONG. 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 888 (Comm. Print 1987) [hereinafter 1986 Bluebook] (stating that section 904(d) is intended to bring about more equal foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries); S. REP. NO. 1983, 85TH CONG., 2D SESS., at 87 (1958), *reprinted in* 1958-3 C.B. 922, 1137 (stating that one of the purposes for enacting subchapter S is to allow businesses to choose their legal forms without undue tax influence).

¹⁰ I.R.C. § 884.

¹¹ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1241(a), 100 Stat. 2085, 2576 (1986).

¹² See 1986 Bluebook, *supra* note 9, at 1036-37; S. REP. NO. 99-313, at 401 (1986), *reprinted in* 1986-3 C.B. (Vol. 3) 401; H.R. REP. NO. 99-426, at 432 (1985), *reprinted in* 1986-3 C.B. (Vol. 2) 432.

¹³ See 1986 Bluebook, *supra* note 9, at 1036-37; S. REP. NO. 99-313, *supra* note 12, at 403; H.R. REP. NO. 99-426, *supra* note 12, at 433-34.

¹⁴ See 1986 Bluebook, *supra* note 9, at 1036-37; S. REP. NO. 99-313, *supra* note 12, at 401; H.R. REP. NO. 99-426, *supra* note 12, at 432-33.

branch,¹⁵ what some commentators have referred to as a surtax result.¹⁶ Moreover, a typical U.S. subsidiary has greater flexibility in retaining earnings as compared to a U.S. branch.¹⁷ The more burdensome nature of the branch profits tax appears to create a tax bias in favor of operating in the United States through U.S. subsidiaries, so that foreign corporations can control the timing and the impact of the second-level tax.¹⁸ Thus, as currently crafted, the branch profits tax fails to promote neutrality adequately.

This article recommends certain changes to the branch profits tax that advance the neutrality policy underlying the provision.¹⁹ More specifically, the article proposes measures that provide foreign corporations operating through U.S. branches with an ability to control the timing and impact of the second-level tax that is similar to that possessed by foreign corporations operating through U.S. subsidiaries. While there may be other ways of achieving neutrality in the imposition of second-level taxes,²⁰ the article proposes measures that make the branch profits tax more equivalent to the dividend tax

¹⁵ See Brown, *supra* note 4, at 196–97.

¹⁶ See *Institute of International Bankers Says to Liberalize Branch Tax Regulations*, TAX NOTES TODAY (Nov. 7, 1988) (LEXIS, FEDTAX lib., TNT file, elec. cit., 88 TNT 225-26) [hereinafter *Institute of International Bankers Comments*]; *International Commercial Bank of China Rejects Method for Determining U.S. Net Equity*, TAX NOTES TODAY (Jan. 11, 1989) (LEXIS, FEDTAX lib., TNT file, elec. cit., 89 TNT 9-23) [hereinafter *International Commercial Bank of China Comments*]; *KPMG Peat Marwick Suggests Modifications to the Branch Profits Tax Regulations as Applied to Banking Institutions*, TAX NOTES TODAY (Jan. 12, 1989) (LEXIS, FEDTAX lib., TNT file, elec. cit., 89 TNT 10-15) [hereinafter *Peat Marwick Comments*].

¹⁷ See *infra* Part III.B.

¹⁸ See, e.g., Michael Hirschfeld & Shaul Grossman, *Opportunities for the Foreign Investor in U.S. Real Estate — If Planning Comes First*, 94 J. TAX'N 36, 38–39 (2001). In this regard, there may be many legitimate business reasons for using a branch rather than a subsidiary for conducting a U.S. business. Cf. Gary D. Sprague, *Application of Transfer Pricing Rules to Branches and Permanent Establishments — Electronic Commerce and Intangible Property Aspects*, 10 GEO. MASON L. REV. 971, 973 (2002) (listing possible business reasons for using a branch as opposed to a subsidiary for foreign operations).

¹⁹ It should be emphasized that even with neutrality in the application of second-level taxes, there would still be significant differences in the taxation of U.S. branches and U.S. subsidiaries of foreign corporations. See Brown, *supra* note 4, at 195–200. More complete neutrality in taxing branches and subsidiaries could be realized by treating a U.S. branch as a separate entity for tax purposes. See *id.* at 152–58, 193.

²⁰ Possibilities range from imposing surtaxes without regard to remittances for both branches and subsidiaries to partially or fully exempting such structures from second-level taxes.

that applies in the subsidiary setting, aiming to accomplish what Congress apparently set out to do in enacting the branch profits tax as a surrogate for the dividend tax.²¹ In addressing these reforms, the article examines whether the proposed measures conflict with other recognized policies governing the taxation of foreign corporations with U.S. branches, ultimately concluding that they do not.

Part II of this article discusses the branch profits tax, its underlying policy goals, and the conceptualization of a U.S. branch that was used by Congress in enacting the provision. Part III compares the branch profits tax to the dividend tax that applies in the U.S. subsidiary setting, pointing out important substantive differences in the operation of these taxes. These differences include the surtax result²² and the greater flexibility of U.S. subsidiaries in retaining earnings.

Part IV then proposes and analyzes several changes to the branch profits tax that would advance neutrality by having the branch profits tax function more like the dividend tax. To address the surtax result, this Part proposes two changes aimed at increasing the usefulness of the current rule that permits a foreign corporation to avoid deemed remittances of U.S. branch earnings by reducing the amount of liabilities imputed to the U.S. branch. To enhance the flexibility of U.S. branches in retaining earnings, this Part recommends providing foreign corporations with an election to treat assets as “effectively connected,” that is, considered as belonging to the U.S. branch for tax purposes. While these measures arguably conflict with the policies underlying the rules for apportioning interest expense and determining effectively connected income, an examination of the potential conflicts suggests that the measures are consistent with these

²¹ The most direct way of modeling a dividend tax in the branch setting would be to monitor and tax directly remittances made by the U.S. branch to other branches of the foreign corporation. See 1 AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 145 (1987) [hereinafter AMERICAN LAW INSTITUTE]. Congress did not use this approach, apparently because it felt that such an approach would not be feasible. See BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 67–198 (2003). Congress probably was also influenced by the fact that the United States generally does not attach tax significance to interbranch transactions. Cf. AMERICAN LAW INSTITUTE, *supra*, at 145 (rejecting a direct monitoring approach in part for this reason). However, if the United States were to treat a U.S. branch as a separate entity for tax purposes, which would include the recognition of interbranch transactions, a direct approach for monitoring and taxing U.S. branch remittances should be feasible and appropriate. See Brown, *supra* note 4, at 152–55.

²² See *supra* notes 15–16 and accompanying text.

and other recognized policies governing the taxation of foreign corporations with U.S. branches. Part V summarizes and concludes the article.

II. THE BRANCH PROFITS TAX AND ITS POLICY GOALS

Congress enacted the branch profits tax in order to reduce the disparity between the taxation of U.S. subsidiaries and U.S. branches of foreign corporations.²³ In general, Congress believed that the same substantive tax rules should apply to both forms of conducting a U.S. business by foreign corporations.²⁴ A U.S. subsidiary of a foreign corporation is subject to net basis U.S. taxation on its earnings.²⁵ In addition, a gross basis U.S. tax (collected by withholding) is imposed on dividends paid by the U.S. subsidiary to the foreign parent.²⁶ A foreign corporation operating through a U.S. branch is also subject to net basis U.S. taxation on its U.S. earnings.²⁷ However, prior to the enactment of the branch profits tax, there rarely was a second-level U.S. tax on the distributed U.S. profits of a foreign corporation

²³ See 1986 Bluebook, *supra* note 9, at 1036; S. REP. NO. 99-313, *supra* note 12, at 401; H.R. REP. NO. 99-426, *supra* note 12, at 432.

²⁴ See 1986 Bluebook, *supra* note 9, at 1036; S. REP. NO. 99-313, *supra* note 12, at 401.

²⁵ See I.R.C. §11.

²⁶ Under section 881(a), a foreign corporation generally is subject to a thirty percent tax on U.S. source dividends (along with other FDAP income such as interest and royalties), with the tax collected through withholding from the dividend payments pursuant to section 1442(a). Dividends paid by a domestic corporation are usually treated as U.S. source income. See I.R.C. § 861(a)(2). The type of taxation imposed under section 881(a), that is, gross income subject to flat rates with no allowance of deductions, is referred to as gross basis taxation. Tax treaties may reduce or eliminate the tax under section 881(a). See, e.g., UNITED STATES MODEL INCOME TAX CONVENTION OF SEPTEMBER 20, 1996, arts. 10–12, <http://www.irs.gov/pub/irs-trty/usmodel.pdf> [hereinafter MODEL CONVENTION].

²⁷ Section 882(a) provides that a foreign corporation is subject to taxation under section 11 on its taxable income which is effectively connected with the conduct of a trade or business within the United States (“effectively connected taxable income”). See I.R.C. § 882(a). Effectively connected taxable income generally is defined as effectively connected income less deductions that are properly allocated and apportioned to such income pursuant to Treasury regulations. See I.R.C. § 882(c)(1)(A). Effectively connected income is generally income that bears some connection to a foreign person’s U.S. business. See I.R.C. § 864(c); *infra* notes 109–38 and accompanying text. The type of taxation imposed under section 882(a), that is, gross income less deductions, taxed at graduated rates, is referred to as net basis taxation. Tax treaties may reduce or eliminate the tax under section 882(a). See, e.g., MODEL CONVENTION, *supra* note 26, at arts. 5, 7.

operating in branch form.²⁸ No U.S. tax was imposed on inter-branch remittances of U.S. earnings. While a second-level withholding tax was possible upon the payment of dividends by the foreign corporation to its foreign shareholders, the withholding tax applied only when at least fifty percent of the gross income of the foreign corporation was effectively connected with its U.S. business.²⁹ In this regard, Congress understood that nearly all foreign corporations operating in the United States through branches avoided the withholding tax by keeping their U.S. income below the fifty percent threshold.³⁰ The result was that foreign corporations with U.S. branches were usually not subject to a second-level tax, while foreign corporations with U.S. subsidiaries were, creating a tax incentive to operate through a U.S. branch, thus violating tax neutrality. In this regard, a second-level tax for U.S. branches functions as a backstop to the dividend tax in U.S. subsidiary setting, as without it the dividend tax could be avoided by using a U.S. branch to conduct U.S. business activities.³¹

Congress believed that simply reducing the threshold for applying the withholding tax would not sufficiently reduce the disparity in the taxation of U.S. branches and U.S. subsidiaries.³² In Congress's view, a second-level tax should not depend on whether U.S. income rose to some arbitrary level, and that such an approach presented administrative problems because it was difficult to know when the tax applied and difficult to enforce if it did apply.³³ Instead, Congress enacted a tax on the U.S. branch profits of a foreign corporation as a substitute for the dividend tax that applies to a foreign corporation with a U.S. subsidiary.³⁴ Under the branch profits tax, a second-level tax generally is imposed on the U.S. earnings of the foreign corporation that are treated as remitted outside of the United States.³⁵

²⁸ See 1986 Bluebook, *supra* note 9, at 1036–37; S. REP. NO. 99-313, *supra* note 12, at 401; H.R. REP. NO. 99-426, *supra* note 12, at 432.

²⁹ See 1986 Bluebook, *supra* note 9, at 1036–37; S. REP. NO. 99-313, *supra* note 12, at 401; H.R. REP. NO. 99-426, *supra* note 12, at 432.

³⁰ See 1986 Bluebook, *supra* note 9, at 1036–37; S. REP. NO. 99-313, *supra* note 12, at 401; H.R. REP. NO. 99-426, *supra* note 12, at 432.

³¹ See AMERICAN LAW INSTITUTE, *supra* note 21, at 140–41.

³² See 1986 Bluebook, *supra* note 9, at 1037.

³³ See 1986 Bluebook, *supra* note 9, at 1036–37; S. REP. NO. 99-313, *supra* note 12, at 401–02; H.R. REP. NO. 99-426, *supra* note 12, at 432–33.

³⁴ See 1986 Bluebook, *supra* note 9, at 1037; S. REP. NO. 99-313, *supra* note 12, at 401–02; H.R. REP. NO. 99-426, *supra* note 12, at 432–33.

³⁵ See 1986 Bluebook, *supra* note 9, at 1037; S. REP. NO. 99-313, *supra* note 12, at 403; H.R. REP. NO. 99-426, *supra* note 12, at 433–34.

Specifically, section 884(a) imposes a thirty percent tax on a foreign corporation's dividend equivalent amount,³⁶ that is, the U.S. branch earnings that are treated as remitted outside of the United States.³⁷ The dividend equivalent amount is defined as a foreign corporation's earnings and profits for the year that is attributable to its effectively connected income ("effectively connected E&P"),³⁸ subject to two adjustments.³⁹ First, effectively connected E&P is reduced by any increase in U.S. net equity for the year, and second, this amount is increased by any annual reduction in U.S. net equity to the extent of the aggregate amount of effectively connected E&P accumulated in years after 1986.⁴⁰ U.S. net equity is defined as U.S. assets less U.S. liabilities.⁴¹ U.S. assets are generally assets that

³⁶ I.R.C. § 884(a). Tax treaties can eliminate or reduce the branch profits tax. Specifically, many older treaties override the branch profits tax because of their nondiscrimination articles, which generally prohibit a treaty country from taxing a permanent establishment of a nonresident enterprise less favorably than a resident enterprise carrying on the same activities. In this regard, Treas. Reg. § 1.884-1(g)(3) provides a list of countries whose treaties with the United States as of January 1, 1987 prevent the imposition of the branch profits tax, provided that the treaty remains in effect and has not been modified after January 1, 1987 to expressly allow for the imposition of the branch profits tax. Treas. Reg. § 1.884-1(g)(3) (1996). More recent treaties (and some older treaties) allow for the imposition of the branch profits tax, but reduce the rate of taxation to the rate applying to dividends paid to a foreign corporation by a wholly-owned U.S. corporation, that rate typically being five or ten percent. *See, e.g.*, MODEL CONVENTION, *supra* note 26, at art. 10, paras. 2(a), 9. The Code makes direct provision for this as well. *See* I.R.C. § 884(e)(2); Treas. Reg. § 1.884-1(g)(4)(i)(A) (1996) (if the treaty does not specify a rate on branch profits, the rate is the same as that which would apply under the treaty to dividends paid to a foreign corporation by a wholly-owned U.S. corporation). To be entitled to treaty benefits for purposes of the branch profits tax, a foreign corporation must meet the requirements of the limitations on benefits provision (if any) contained in the treaty, and in addition, either the foreign corporation is a qualified resident of the treaty country within the meaning of section 884(e)(4) and Treas. Reg. § 1.884-5(a), or the limitations on benefits provision, or an amendment thereto, entered into force after December 31, 1986. *See* Treas. Reg. § 1.884-4(g)(1) (1996).

³⁷ *See* 1986 Bluebook, *supra* note 9, at 1039; S. REP. NO. 99-313, *supra* note 12, at 403; H.R. REP. NO. 99-426, *supra* note 12, at 433-34.

³⁸ Treas. Reg. § 1.884-1(f) elaborates on the determination of effectively connected E&P, which is similar to the determination of E&P of domestic corporations except that effectively connected taxable income is used in lieu of taxable income. *Cf.* I.R.C. § 312.

³⁹ *See* I.R.C. § 884(b).

⁴⁰ *Id.*

⁴¹ *See* I.R.C. § 884(c)(1).

produce effectively connected income,⁴² and U.S. liabilities are essentially the liabilities attributed to the U.S. branch for purposes of determining the interest expense deduction taken against effectively connected income.⁴³ These adjustments for changes in U.S. net equity are aimed at measuring indirectly the effectively connected E&P that is remitted by the U.S. branch outside of the United States.⁴⁴

In examining the branch profits tax for reforms in light of its underlying policy, it is also important to consider Congress's conceptualization of a U.S. branch that was used in enacting the provision.⁴⁵ The purpose and structure of the branch profits tax indicate that Congress viewed a U.S. branch of a foreign corporation as a constructive U.S. subsidiary for purposes of imposing a second level of U.S. tax on the earnings of the branch.⁴⁶ The very fact that

⁴² See I.R.C. § 884(c)(2); Treas. Reg. § 1.884-1(d) (1996). See *infra* notes 101–38 and accompanying text for details on the definition of U.S. assets.

⁴³ See I.R.C. § 884(c)(2); Treas. Reg. § 1.884-1(e) (1996). Treas. Reg. § 1.882-5 uses a three-step process to determine the amount of a foreign corporation's interest expense deduction that is allocated and apportioned to effectively connected income. See Treas. Reg. § 1.882-5 (1996). First, the foreign corporation determines the average total value of its U.S. assets (which are generally defined the same as under the branch profits tax). Second, the foreign corporation determines the amount of its worldwide liabilities that are imputed to its U.S. business ("U.S.-connected liabilities") by multiplying its U.S. assets by either (i) its actual worldwide liability-to-asset ratio or (ii) a fixed ratio, which is ninety-three percent for banks and fifty percent for foreign corporations other than banks or insurance companies. Finally, the foreign corporation determines interest expense deduction by imputing an interest rate to U.S.-connected liabilities using one of two possible methods (the adjusted U.S. booked liabilities method or the separate currency pools method). For purposes of determining U.S. net equity under the branch profits tax, U.S. liabilities are generally defined as the amount of U.S.-connected liabilities (as defined under Treas. Reg. § 1.882-5) if U.S.-connected liabilities were determined using the assets and liabilities of the foreign corporation as of the close of the particular taxable year (rather than the average amount of assets and liabilities for the year). See Treas. Reg. § 1.884-1(e)(1) (1996).

⁴⁴ See 1986 Bluebook, *supra* note 9, at 1039.

⁴⁵ See Steven A. Musher, *Coping with the Branch Tax Temporary Regulations: Part I*, 71 J. TAX'N 110, 115 (1989) (likening a U.S. branch to a "shadow" U.S. subsidiary and using this comparison to measure how well the regulations achieve parallel treatment of U.S. branches and subsidiaries). This analogy, along with the underlying policy identified above, will form the basis for the reforms recommended in this article.

⁴⁶ See Peter H. Blessing, *The Branch Tax*, 40 TAX LAW. 587, 590 n.23 (1987); Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173, 176 n.26 (1989); Fred Feingold & Mark E. Berg, *Whither the Branches?*, 44 TAX L. REV. 205,

Congress enacted the provision in order to reduce the disparity between the taxation of U.S. branches and U.S. subsidiaries suggests that Congress considered these two forms of conducting a U.S. business as equivalents for certain tax purposes. Because the two forms are considered equivalents, concerns of tax neutrality call for more similar tax treatment with regard to exacting a second level of tax on U.S. earnings. The structure of the tax Congress enacted supports this reading as well. The determination of a "dividend equivalent amount," which imputes the remittance of earnings from the U.S. branch, is modeled on the determination of a dividend, which similarly tracks the distribution of earnings from a U.S. subsidiary.⁴⁷

Indeed, other provisions contained within section 884 expressly treat a U.S. branch as a constructive U.S. subsidiary for certain tax purposes. Section 884(e)(2) provides that for purposes of applying income tax treaties to reduce the rate of the branch profits tax, the treaty rate will be that which applies to dividends paid to the foreign corporation by a wholly-owned U.S. subsidiary, if the treaty does not specify a rate on branch profits.⁴⁸ In addition, for purposes of sourcing interest income, section 884(f)(1)(A) treats interest paid by a U.S. branch of a foreign corporation as if it were paid by a U.S. corporation.⁴⁹ Section 884(f)(1)(B) further provides that to the extent that a foreign corporation's interest expense deduction under Treas. Reg. § 1.882-5⁵⁰ exceeds the interest paid by the U.S. branch, the excess interest will be taxable as if the amounts were paid to the foreign corporation by a wholly-owned U.S. subsidiary.⁵¹ Similar to

209 (1989).

⁴⁷ See Musher, *supra* note 45, at 110.

⁴⁸ As noted earlier, a foreign corporation that is resident of a treaty country would need to satisfy certain requirements in order for the treaty to eliminate or reduce the foreign corporation's liability under the branch profits tax. See *supra* note 36.

⁴⁹ I.R.C. § 884(f)(1)(A). Treas. Reg. § 1.884-4(b) provides rules for determining the interest that is paid by a U.S. branch ("branch interest"). See Treas. Reg. § 1.884-4(b) (1996). In general, branch interest is defined as interest paid by the foreign corporation on its U.S. booked liabilities. See Treas. Reg. § 1.884-4(b)(1) (1996). See *infra* note 69 for a description of U.S. booked liabilities.

⁵⁰ See *supra* note 43.

⁵¹ I.R.C. § 884(f)(1)(B). Accordingly, the excess interest generally will be subject to a thirty percent tax in the absence of a treaty reduction or exemption. See I.R.C. § 881(a); Treas. Reg. § 1.884-4(a)(2). Treas. Reg. § 1.884-4 contains specific rules for implementing the so-called excess interest tax, including an exemption from the tax and its coordination with treaty provisions. See Treas. Reg. § 1.884-4(a)(2), (c)(3) (1996). With respect to foreign banks, at least eighty-five percent of the bank's

the branch profits tax, these interest provisions aim to promote neutrality by ensuring that a deduction for interest allowed against the U.S. tax base generally gives rise to an interest inclusion subject to U.S. tax, which is the case in the context of a U.S. subsidiary.⁵²

III. THE BRANCH PROFITS TAX VERSUS THE DIVIDEND TAX

There are obvious differences in the methods used for exacting a second level of U.S. tax on remittances of earnings in the U.S. branch and subsidiary settings. As described above, the branch profits tax employs a formulary approach to determine (and tax) remittances of effectively connected E&P by the U.S. branch to other branches of the foreign corporation.⁵³ In contrast, the dividend tax applies to actual distributions by a U.S. subsidiary to its foreign parent.⁵⁴ From the standpoint of neutrally applying a second-level tax, using different methods for the branch and subsidiary settings would not be problematic if the substantive results were substantially similar. This, however, is not the case.

A. Imputed Liabilities and the Automatic Nature of the Branch Profits Tax

Under the branch profits tax, a foreign corporation can be subject to a second-level tax even when all of its effectively connected E&P is invested in U.S. branch assets.⁵⁵ Thus, unlike the application of the

excess interest will be treated as deposit interest and exempt from the tax. See Treas. Reg. § 1.884-4(a)(2)(iii) (1996). Treaties can apply to reduce the rate of taxation to the rate applying to interest paid to a foreign corporation by a U.S. corporation, that rate typically being zero percent. See Treas. Reg. § 1.884-4(c)(3) (1996); see, e.g., MODEL CONVENTION, *supra* note 26, at art. 11, para. 1. To be entitled to treaty benefits for purposes of the excess interest tax, a foreign corporation must meet the requirements of the limitations on benefits provision (if any) contained in the treaty, and in addition, either the foreign corporation is a qualified resident of the treaty country within the meaning of section 884(e)(4) and Treas. Reg. § 1.884-5(a), or the limitations on benefits provision, or an amendment thereto, entered into force after December 31, 1986. See Treas. Reg. § 1.884-4(c)(3)(i) (1996).

⁵² See 1986 Bluebook, *supra* note 9, at 1037.

⁵³ See *supra* notes 36–44 and accompanying text.

⁵⁴ See *supra* note 26 and accompanying text.

⁵⁵ See Alfred C. Groff & James F. Hoch, *Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks*, 1988 U. ILL. L. REV. 343, 363; Brown, *supra* note 4, at 196–97; *Institute of International Bankers Comments*, *supra* note 16; *International Commercial Bank of China Comments*, *supra* note 16; *Peat Marwick Comments*, *supra* note 16.

dividend tax in the case of a U.S. subsidiary, a branch profits tax liability can occur in the absence of an actual remittance of U.S. earnings. This is due to the fact that in determining increases and decreases in U.S. net equity for purposes of the tax, U.S. liabilities are essentially those that are imputed under Treas. Reg. § 1.882-5 in the determination of the interest expense deduction allocated to effectively connected income,⁵⁶ as opposed to the actual booked liabilities of the U.S. branch.⁵⁷ For example, assume that a foreign corporation has \$1,000,000 of effectively connected E&P for a particular year, and reinvests all of the E&P in U.S. assets.⁵⁸ There are no other changes in the amount of the foreign corporation's U.S. assets for the year. Assume that the foreign corporation determines its interest expense deduction under Treas. Reg. § 1.882-5 by using the fifty percent fixed liabilities-to-assets ratio to impute liabilities to its U.S. branch.⁵⁹ Under these facts, the foreign corporation would have a dividend equivalent amount of \$500,000 for the year, which is equal to its effectively connected E&P of \$1,000,000 reduced by its increase in U.S. net equity of \$500,000 (\$1,000,000 increase in U.S. assets less \$500,000 increase in U.S. liabilities).⁶⁰ Consequently, the foreign corporation is deemed to have remitted \$500,000 of effectively connected E&P despite there being no actual remittances.⁶¹

⁵⁶ See *supra* note 43.

⁵⁷ See Groff & Hoch, *supra* note 55, at 363; Brown, *supra* note 4, at 196–97; *Institute of International Bankers Comments*, *supra* note 16; *International Commercial Bank of China Comments*, *supra* note 16; *Peat Marwick Comments*, *supra* note 16.

⁵⁸ See *supra* note 42 and accompanying text.

⁵⁹ See *supra* note 43.

⁶⁰ See *supra* notes 41–43 and accompanying text. The increase in U.S. liabilities (\$500,000) would equal the increase in U.S. assets (\$1,000,000) multiplied by the fixed liability-to-asset ratio (.5).

⁶¹ See Blessing, *supra* note 46, at 602; Musher, *supra* note 45, at 113 n.9. While the example in the text involves the use of the fixed liability-to-asset ratio, a similar result is possible for a foreign corporation using its actual liability-to-asset ratio to determine its interest deduction allocated to effectively connected income. For example, where, for a particular year, a foreign corporation's U.S. operations are relatively more profitable than its foreign operations, and all earnings are retained in the branch that earned them, the U.S. branch will draw a greater portion of the foreign corporation's liabilities as compared to the prior year using the actual ratio. See Peter J. Genz, *Planning for Inbound Foreign Investment Under the Final Branch Tax Regulations — Part I*, 22 TAX MGMT. INT'L J. 118, 132 (1993); Musher, *supra* note 45, at 112. As a result, where the foreign corporation's total liabilities remained unchanged from the prior year, the amount of U.S. liabilities will increase for the current year, causing a dividend equivalent amount to this extent even if all effectively connected E&P for the year is invested in U.S. assets.

These results are inconsistent with the neutrality policy underlying the branch profits tax in the sense that a dividend tax would not be imposed automatically in the absence of an actual distribution by a U.S. subsidiary.⁶² However, defining U.S. liabilities by reference to liabilities imputed under Treas. Reg. § 1.882-5 is in accordance with the policy of neutrality. This is because in both the branch and subsidiary settings, U.S. earnings will be subject to a second-level tax to the extent that they no longer generate taxable income subject to net basis taxation by the United States.⁶³ To explain in terms of the previous example, because of interest deductions on the additional liabilities of \$500,000, only \$500,000 of the \$1,000,000 in effectively connected E&P should be viewed as generating income subject to net basis U.S. taxation in subsequent years. The remaining \$500,000 in effectively connected E&P should be treated as remitted outside of the U.S. branch given that this amount effectively is outside the scope of such taxation. This is also the case for a U.S. subsidiary with \$1,000,000 of E&P that first borrowed \$500,000 from its foreign parent and then distributed \$500,000 to the parent, in that only \$500,000 of earnings would continue to generate income subject to net basis U.S. taxation.⁶⁴

Of course, there is an important difference in the application of the second-level taxes in the branch and subsidiary settings: a foreign corporation with a U.S. branch does not have the same ability to control the timing of the second-level tax as does a foreign corporation with a U.S. subsidiary.⁶⁵ The latter can avoid a current dividend tax on U.S. earnings by having the U.S. subsidiary retain its earnings; unlike the treatment of a U.S. branch, liabilities will not be

⁶² See Brown, *supra* note 4, at 196-97; *Institute of International Bankers Comments*, *supra* note 16.

⁶³ See Brown, *supra* note 4, at 197; *cf.* Groff & Hoch, *supra* note 55, at 363 (stating that it is arguably not unreasonable to impose a cost where a foreign bank has benefited from the fixed ratio in computing its interest deductions). In this regard, Congress intended for U.S. net equity to include only those assets and liabilities that generate income taxable by the United States on a net basis. See 1986 Bluebook, *supra* note 9, at 1040.

⁶⁴ Treasury similarly justifies the use of imputed liabilities on neutrality grounds by pointing out that if a U.S. business were conducted in a U.S. subsidiary, the subsidiary's assumption of a portion of the foreign parent's liabilities with no resulting increase in assets would be treated as a dividend distribution from the subsidiary to the parent. See Preamble to Temporary and Proposed Regulations under Section 884, *reprinted in Service Issues Branch Profits Tax Regulations*, TAX NOTES TODAY (Aug. 30, 1988) (LEXIS, FEDTAX lib., TNT file, elec. cit., 88 TNT 178-2).

⁶⁵ See Brown, *supra* note 4, at 197; Musher, *supra* note 45, at 112.

imputed to earnings retained by a U.S. subsidiary. Moreover, there appears to be little possibility that the accumulated earnings tax would apply to the retained earnings of the U.S. subsidiary as a surrogate for a second-level tax, and the personal holding company tax, even if potentially applicable, should still allow for generous accumulations without the risk of penalty.⁶⁶ Thus, the typical U.S. subsidiary conducting a business should have a good deal of flexibility in avoiding dividend and corporate penalty taxes by retaining earnings in either business or nonbusiness assets. In contrast, the branch profits tax can apply automatically, regardless of how much effectively connected E&P is invested in U.S. branch assets, as the example above indicates.⁶⁷

Treas. Reg. § 1.884-1(e)(3) does provide some relief from the automatic application of the branch profits tax by allowing for an election to reduce U.S. liabilities for purposes of both determining U.S. net equity under the branch profits tax and calculating the U.S. branch's interest deduction under Treas. Reg. § 1.882-5.⁶⁸ Under Treas. Reg. § 1.884-1(e)(3), U.S. liabilities cannot be reduced below the amount of U.S. booked liabilities.⁶⁹ Thus, in the previous

⁶⁶ For an explanation of the application of the corporate penalty taxes in the subsidiary setting, see *infra* notes 83–98 and accompanying text.

⁶⁷ See *supra* notes 58–61 and accompanying text.

⁶⁸ A reduction in U.S. liabilities for branch profits tax purposes requires a corresponding reduction in U.S.-connected liabilities for purposes of Treas. Reg. § 1.882-5. See Treas. Reg. § 1.884-1(e)(3)(iii) (1996). This in turn can lower a foreign corporation's excess interest tax liability. See *id.*; *supra* notes 50–52 and accompanying text. Treasury's stated purpose for providing the election to reduce liabilities is to permit a foreign corporation to accumulate earnings in non-U.S. assets for later capital investment in the U.S. business. See T.D. 8432, 1992-2 C.B. 157, 163. In this regard, the liability reduction election replaced the expansion capital election contained in the proposed and temporary regulations. See *id.*; *infra* note 240. The latter was viewed by Treasury as ineffective (because of the possible imputation of additional U.S. liabilities on elected assets) and complex (if properly drafted) in permitting accumulations of expansion capital in what would otherwise be non-U.S. assets. See T.D. 8432, 1992-2 C.B. 157, 163.

⁶⁹ Treas. Reg. § 1.884-1(e)(3)(ii) (1996). Specifically, the floor on reducing U.S. liabilities is the amount of U.S. booked liabilities as of the determination date (generally the close of the taxable year), increased by the amount of any liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset under Treas. Reg. § 1.861-10T, as well as by the amount of certain liabilities of foreign insurance companies that are described in Treas. Reg. § 1.884-1(e)(2)(i). See Treas. Reg. § 1.884-1(e)(3)(ii) (1996). U.S. booked liabilities are generally defined as liabilities that are treated as properly reflected on the books of the U.S. business based on certain standards set forth in the regulations. Treas. Reg. § 1.882-5(d)(2)(i) (1996). More specifically, for nonbanks, U.S. booked liabilities include liabilities

example, the foreign corporation may be able to reduce its U.S. liabilities by \$500,000, which would result in a dividend equivalent amount of zero for the particular year (effectively connected E&P of \$1,000,000 reduced by an increase in U.S. net equity of \$1,000,000).⁷⁰ However, the foreign corporation could only do so if its U.S. liabilities prior to the reduction exceeded its U.S. booked liabilities by at least the amount of the desired reduction in U.S. liabilities, in this case \$500,000. In addition, the regulations generally provide that to the extent the foreign corporation does not ultimately make investments resulting in additional U.S. net equity in an amount equal to the earnings accumulating as a result of the election, the foreign corporation must recapture that amount as a dividend equivalent amount in the year that the U.S. branch is completely terminated.⁷¹

secured by U.S. assets of the foreign corporation and liabilities entered on the books of the foreign corporation's U.S. business at a time that is reasonably contemporaneous with the time that the liability is incurred, among other liabilities. Treas. Reg. § 1.882-5(d)(2)(ii) (1996). For banks, U.S. booked liabilities include liabilities that are timely entered on the books of the foreign corporation's U.S. business, provided the liabilities have a direct connection or relationship to the U.S. business. Treas. Reg. § 1.882-5(d)(2)(iii)(A) (1996).

⁷⁰ The liability reduction election is effective only for determining U.S. net equity for the taxable year for which the election is made. See Treas. Reg. § 1.884-1(e)(3), (e)(5), ex. 2; Genz, *supra* note 61, at 133. Therefore, if U.S. assets and U.S. liabilities otherwise remain constant, a foreign corporation will have to continue to make the election in succeeding years in order to continue to defer the branch profits tax. See Treas. Reg. § 1.884-1(e)(5), ex. 2; Genz, *supra* note 61, at 133. In addition, because of the corresponding reduction in the amount of U.S.-connected liabilities and resulting interest deductions, the liability reduction election, while increasing U.S. net equity, may also increase effectively connected E&P. See Treas. Reg. § 1.884-1(e)(5), ex. 2. This may necessitate a further reduction in U.S. liabilities to avoid a dividend equivalent amount. See *id.*; Genz, *supra* note 61, at 133 (explaining that a foreign corporation may need to use algebra to determine the amount of the liability reduction needed to avoid any dividend equivalent amount).

⁷¹ See Treas. Reg. § 1.884-1(e)(3)(v) (1996). Technically, recapture occurs because of an election to reduce U.S. liabilities for the year preceding the year of the complete termination. This assumes that the election contributed to the foreign corporation's accumulated effectively connected E&P that existed at the time of the complete termination. See *id.* (upon complete termination of the U.S. branch, the branch profits tax is imposed on a dividend equivalent amount equal to the lesser of "(i) the foreign corporation's accumulated effectively connected E&P that is attributable to the liability reduction election or (ii) the liability reduction that is in effect for the taxable year preceding the year of the complete termination"). A subsequent increase in U.S. net equity would allow a foreign corporation to discontinue its liability reduction election by the amount of the increase, without generating a dividend equivalent amount for the particular year. Therefore, a foreign corporation can avoid the recapture rule by increasing its investment in U.S. net

On the facts of the example given above, this means that the foreign corporation would eventually need to increase its U.S. net equity by \$500,000, the amount of earnings accumulating as a result of the liability reduction, in order to avoid recapture. To do so, the foreign corporation would have to invest an additional \$1,000,000 in U.S. assets because of the additional U.S. liabilities that would result from additional U.S. assets.⁷²

With these features, the liability reduction election apparently is not very useful to foreign corporations in controlling the timing of their branch profits tax liability. With the recapture rule, if the taxpayer is not able to make the necessary investments to avoid recapture,⁷³ the benefits of reducing liabilities (the delay in the imposition of the branch profits tax with a possible reduction in excess interest tax liability) may well not outweigh its costs (losing the tax benefit attributable to the forgone interest deductions).⁷⁴ In part for

equity after making an election to reduce liabilities. It should be pointed out that in explaining the recapture rule, Treasury states that recapture will occur if the foreign corporation does not ultimately reinvest the accumulated earnings in additional U.S. assets, as opposed to additional U.S. equity. See T.D. 8432, 1992-2 C.B. 157, 160. This statement seems imprecise given the language of the recapture rule, as analyzed above. For foreign corporations using the fixed liability-to-asset ratio under Treas. Reg. § 1.882-5, investing amounts in additional U.S. assets will not result in additional U.S. net equity equal to the invested amounts given that additional U.S. assets will create additional U.S. liabilities. The same result can occur with the use of the actual liability-to-asset ratio. See *supra* note 61.

Aside from the application of the recapture rule, the complete termination of a U.S. branch generally does not result in the imposition of the branch profits tax. See Temp. Treas. Reg. § 1.884-2T(a) (2006). This is consistent with treating a U.S. branch as a hypothetical U.S. subsidiary for purposes of the branch profits tax, given that a foreign parent is usually not subject to U.S. tax with respect to distributions received upon the liquidation of its U.S. subsidiary. See *infra* notes 146–49 and accompanying text.

⁷² \$1,000,000 in U.S. assets less \$500,000 in U.S. liabilities (fifty percent of \$1,000,000) yields \$500,000 in U.S. net equity. See *supra* note 43 and accompanying text.

⁷³ In this regard, if taxpayers attempted to avoid recapture by investing in U.S. assets just prior to a complete termination of the U.S. branch, the Service may be able to use its authority under Treas. Reg. 1.884-1(d)(5)(ii) to ignore artificial increases in U.S. assets. See Alan S. Lederman & Bobbe Hirsh, *Final Branch Regulations Fail to Clear the Thicket of Complexity*, 78 J. TAX'N 110, 113 (1993).

⁷⁴ Delaying the branch profits tax would allow a foreign corporation to invest and earn a return on the amount of the deferred taxes. Consequently, the annual benefit of delaying the branch profits tax should be equal to the reduction in the amount of liabilities (which would translate into reduced dividend equivalent amount), multiplied by (1) the rate of the branch profits tax and (2) the foreign

this reason,⁷⁵ the election appears to be worthwhile only in limited

corporation's after-tax rate of return. In this regard, the rate of the branch profits tax is normally thirty percent, but could be five percent or less if the foreign corporation is entitled to treaty benefits. See MODEL CONVENTION, *supra* note 26, at art. 10, paras. 2(a), 8, 9. The annual cost of losing the tax benefit attributable to the forgone interest deductions should be equal to the reduction in the amount of liabilities, multiplied by (1) the interest rate imputed to U.S. liabilities under Treas. Reg. § 1.882-5, and by (2) the marginal federal income tax rate that applies to the foreign corporation. In addition, the reduction of U.S. liabilities could generate a tax benefit by reducing excess interest tax liability by an amount equal to thirty percent of the amount of forgone interest deductions; however, in the case of a foreign bank, the excess interest tax reduction will be no more than fifteen percent of this amount (see *supra* note 51), and if the foreign corporation is entitled to treaty benefits, there would likely be no excess interest tax liability in any event. See *id.* Assume that the foreign corporation's after-tax rate of return equals the interest rate imputed under Treas. Reg. § 1.882-5, designated as R, the foreign corporation's marginal tax rate is thirty-five percent, the rates of the branch profits tax and excess interest tax are thirty percent, and the foreign corporation elects to reduce its U.S. liabilities by an amount designated as L, which reduces its dividend equivalent amount by the same amount. In this situation, the annual benefit of the election would be equal to $L \times .30 \times R$ (due to deferral of branch profits tax) plus $L \times .30 \times R$ (reduction of excess interest tax) or $L \times .60 \times R$, which would be greater than the annual cost of the election of $L \times .35 \times R$. However, if the foreign corporation is a bank, the annual benefit of the election would be equal to $L \times .30 \times R$ (due to deferral of branch profits tax) plus $L \times .045 \times R$ (or less) (reduction of excess interest tax) or $L \times .345 \times R$, which would be slightly less than the annual cost of $L \times .35 \times R$. If pursuant to a treaty the foreign corporation is entitled to a branch profits tax rate of five percent and an excess interest tax rate of zero, the annual benefit of the liability reduction election ($L \times .05 \times R$) would be substantially less than the annual cost ($L \times .35 \times R$). Indeed, the latter two situations may well be the typical situations where the liability reduction election is available. This is because the election can only be used where U.S. liabilities exceed U.S. booked liabilities, and foreign corporations other than banks or treaty beneficiaries may take steps to increase their U.S. booked liabilities, see *supra* note 69, to avoid excess interest tax exposure. Cf. Peter J. Connors, 909-3rd T.M. (BNA), *The Branch-Related Taxes of Section 884 A-51* (pointing out that foreign corporations may seek to maximize branch interest and thereby lower excess interest by "overbooking" liabilities to the U.S. branch until the amount of the interest deduction is known). Nevertheless, commentators do note the use of the liability reduction election to reduce excess interest tax exposure, see *infra* notes 76–77, indicating that foreign corporations with such exposure do find themselves in excess U.S. liability situations.

This analysis ignores any foreign and state tax consequences of making the election, which could be a factor. Also, it should be emphasized that this cost/benefit analysis assumes that the foreign corporation would not be able to make the required investments in U.S. assets to avoid recapture.

⁷⁵ Even without the recapture rule, a foreign corporation may not want to forgo interest deductions in exchange for reducing its branch profits tax liability, especially if the foreign corporation is entitled to reduced branch profits tax rate and an exemption from the excess interest tax pursuant to a treaty. This is similar to a

circumstances,⁷⁶ such as where the U.S. branch is operating at a loss for the taxable year,⁷⁷ or where the foreign corporation has current effectively connected E&P but an accumulated deficit.⁷⁸ Importantly, the usefulness of the liability reduction election is curtailed further by the U.S. booked liability limit on reducing U.S. liabilities. Indeed, because of this limitation, the election very likely would be unavailable for a foreign corporation whose liabilities consist entirely

foreign corporation with a U.S. subsidiary that chooses to distribute earnings and incur a dividend tax rather than having income generated by the invested earnings subject to net basis taxation by the United States. *Cf.* Cynthia Blum, *How the United States Should Tax Foreign Shareholders*, 7 VA. TAX REV. 583, 662–66 (1988) (discussing the tax tradeoffs facing a U.S. subsidiary in deciding whether to accumulate or distribute earnings).

⁷⁶ In this regard, one commentator states that the election to reduce liabilities will be most useful for purposes of reducing the excess interest tax contained in section 884(f). *See* Kathleen Matthews, *Canada-Netherlands Protocol Discussion Highlights Annual U.S. IFA Branch Meeting*, 93 TAX NOTES INT'L 49-4 (1993) (pointing out that for companies operating at a loss, the resulting reduction in deductible interest expense will lower their excess interest tax liability while not affecting regular income tax liability because of the net loss situation). Another commentator states that in the absence of treaty protection from the branch profits tax, the election usually makes sense for foreign banks. *See* Yaron Z. Reich, *U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives*, 2 FLA. TAX REV. 1, 65 n.159 (1994). Nevertheless, Reich may not be taking into account the effect of the recapture rule (at least it is not mentioned in his example).

⁷⁷ *See* Paul C. Lau & Rolf Auster, *Structuring U.S. Operations for Foreign Corporations in the Current Tax Climate*, 27 J. CORP. TAX'N 34, 41 (2000); Connors, *supra* note 74, A-15 to -16 (noting that the election may be attractive to a foreign corporation with losses that is otherwise facing an excess interest tax liability); Genz, *supra* note 61, at 133.

⁷⁸ The liability reduction election should be beneficial in the latter situation because the recapture rule provides that the dividend equivalent amount upon the complete termination of the U.S. branch will not exceed the accumulated effectively connected E&P that is attributable to the election to reduce liabilities. *See* Treas. Reg. § 1.884-1(e)(3)(v) (1996). Consequently, if the foreign corporation has a deficit in effectively connected E&P when it completely terminates its U.S. branch, there will be no recapture of previously reduced liabilities. Alternatively, in these circumstances, the taxpayer can discontinue the election for a subsequent year in which there is both negative current and accumulated effectively connected E&P, without incurring a current branch profits tax in that particular year, or a recapture tax upon termination because of the liability reduction limit on recapture. *See id.* Thus, the election also allows a foreign corporation to avoid the tax where it would otherwise be imposed in a manner similar to the “nimble dividend” rule of section 316(a)(2). I.R.C. § 316(a)(2).

of U.S. booked liabilities.⁷⁹ More fundamentally, as demonstrated below, a U.S. subsidiary would not face the potential for a recapture tax following a reduction of its liabilities, nor would it be so limited in its ability to reduce liabilities.⁸⁰

B. Greater Flexibility of U.S. Subsidiaries in Retaining Earnings

In addition to the effects of using imputed liabilities in the branch setting, a U.S. subsidiary has more control over the timing of the dividend tax because of its greater flexibility in retaining earnings than does a U.S. branch. The dividend tax in the U.S. subsidiary setting only applies when earnings are distributed to the foreign parent.⁸¹ Consequently, a foreign parent of a U.S. subsidiary would avoid a dividend tax on any earnings of the subsidiary that are invested in assets of the subsidiary, whether or not the assets are related to the subsidiary's U.S. business activities; this would include earnings that are invested in foreign business assets and portfolio investments.⁸²

There appears to be little possibility that a U.S. subsidiary would be forced to make distributions in order to avoid application of the accumulated earnings tax⁸³ for retaining earnings. In most cases, the accumulated earnings tax apparently cannot apply to a wholly owned U.S. subsidiary of a foreign corporation, regardless of whether the subsidiary accumulates earnings beyond the reasonable needs of its business.⁸⁴ For the accumulated earnings tax to be applicable, Treas. Reg. § 1.532-1(a)(1) requires a purpose to avoid the imposition of the *individual* income tax on a corporation's shareholders, or shareholders

⁷⁹ See Lederman & Hirsh, *supra* note 73, at 113; Genz, *supra* note 61, at 126–27, 133. For this reason, one commentator describes the liability reduction election as a poor replacement for the former expansion capital election, and that a properly-designed expansion capital election would have been much more useful. Genz, *supra* note 61, at 126, 133.

⁸⁰ See *infra* Parts IV.B.1, IV.C.1.

⁸¹ See *supra* note 26 and accompanying text.

⁸² See Blum, *supra* note 75, at 614.

⁸³ See I.R.C. §§ 531–537. In general, the accumulated earnings tax imposes a fifteen percent tax on a corporation's accumulated taxable income if the corporation accumulates earnings for the purpose of avoiding the income tax on its shareholders. See I.R.C. §§ 531, 532.

⁸⁴ Section 533(a) presumes that a corporation accumulates earnings for the purpose of avoiding the income tax on its shareholders when the corporation accumulates earnings beyond the reasonable needs of its business. See I.R.C. § 533(a). The corporation can rebut the presumption by proving the contrary by the preponderance of the evidence. See *id.*

of another corporation, by allowing earnings to accumulate instead of distributing them.⁸⁵ With respect to a wholly owned U.S. subsidiary of a foreign corporation, this purpose can potentially exist only where the foreign parent has individual shareholders who would be subject to U.S. tax on dividends paid by the parent.⁸⁶ With a few minor exceptions, a foreign shareholder is not taxable with respect to dividends paid by a foreign corporation.⁸⁷ Consequently, for the accumulated earnings tax to apply even potentially in the U.S. subsidiary setting, the foreign parent would very likely need to have U.S. individual shareholders.⁸⁸ However, because of the possibility of three levels of U.S. tax, U.S. individuals typically would not want to

⁸⁵ See Treas. Reg. § 1.532-1(a)(1) (1960).

⁸⁶ See, e.g., I.R.S. Priv. Ltr. Rul. 97-09-034 (Feb. 28, 1997); I.R.S. Priv. Ltr. Rul. 94-22-028 (June 3, 1994).

⁸⁷ See I.R.C. § 871(i)(2)(D). Section 871(i)(2)(D), which was added in 2004, only provides an exemption from the FDAP/withholding tax for dividends paid by a foreign corporation that are treated as U.S. source under section 861(a)(2)(B) (which deals with dividends paid by foreign corporations having at least twenty-five percent of its gross income being effectively connected gross income over the previous three years); therefore, in the absence of a treaty exemption, the withholding tax should continue to apply to other situations where dividends paid by foreign corporation are treated as U.S. source, that is, dividends paid out of E&P inherited from U.S. corporations. See I.R.C. § 861(a)(2)(C). There is also the possibility that U.S. source (or even foreign source) dividends paid by a foreign corporation to a foreign individual shareholder could be taxable as effectively connected income; however, this is quite unlikely given the limitations on effectively connecting stock, even if the foreign individual shareholder has a U.S. business. See *infra* note 116 and accompanying text. See generally I.R.C. § 864(c)(2), (c)(4); Treas. Reg. § 1.864-4(c) (2005); Treas. Reg. § 1.864-6(b)(2)(ii) (1972).

⁸⁸ In several private letter rulings, the Service concluded that there was no potential for the application of the accumulated earnings tax to a U.S. corporation owned by foreign corporations that neither have U.S. shareholders nor U.S. businesses. See I.R.S. Priv. Ltr. Rul. 97-09-034 (Feb. 28, 1997); I.R.S. Priv. Ltr. Rul. 94-22-028 (June 3, 1994); I.R.S. Priv. Ltr. Rul. 93-30-010 (July 30, 1993); I.R.S. Priv. Ltr. Rul. 93-30-011 (July 30, 1993); I.R.S. Priv. Ltr. Rul. 92-29-025 (July 17, 1992). With the enactment in 2004 of section 871(i)(2)(D), see *supra* note 87, it is less relevant for these purposes whether the foreign corporation has a U.S. business. Prior to this exemption, the existence of a U.S. business was quite relevant, as such could result in the dividends from the foreign corporation being treated as U.S. source and thus taxable in the hands of a foreign individual shareholder under the FDAP/withholding tax. With the enactment of section 871(i)(2)(D), whether the foreign parent conducts a U.S. business is only relevant for purposes of determining the source of the dividends in applying the rules for determining effectively connected income; regardless of the source of the dividend income, it is very unlikely that dividends would be taxable as effectively connected income in the hands of foreign individual shareholders of the foreign parent. See *supra* note 87.

own stock in a privately-held foreign corporation that in turn has a U.S. subsidiary.⁸⁹ A widely-held foreign corporation may well have some U.S. individual shareholders, either direct or indirect. However, while possible,⁹⁰ it appears quite unlikely that a subsidiary of a widely-held parent would be found to be formed or availed of to avoid the individual tax on the parent's shareholders.⁹¹ This should especially be the case for a U.S. subsidiary of a widely-held foreign corporation, whose majority of shareholders would presumably be foreign persons who rarely would be taxable on dividends paid by the foreign corporation.⁹² It seems very unlikely that such a U.S. subsidiary would be found to accumulate earnings in order to avoid the individual tax on the foreign parent's U.S. shareholders, where U.S. persons only constitute a minority of the parent's shareholders.⁹³ Thus, most U.S. subsidiaries of foreign corporations would appear to be able to retain earnings without the limitations imposed pursuant to the accumulated earnings tax.

⁸⁹ See Fred B. Brown, *Wither FIRPTA?*, 57 TAX LAW. 295, 325 (2004); cf. Genz, *supra* note 61, at 137 (pointing out that it will often be the case that dividends paid by a foreign parent of a U.S. subsidiary to its individual shareholders will not be taxable by the United States, thus implying that the shareholders typically will not be U.S. persons).

⁹⁰ See I.R.C. § 532(c) (stating that accumulated earnings tax is applied without regard to the number of shareholders).

⁹¹ Professors Bittker and Eustice point out that although section 532(c) allows for the application of the accumulated earnings tax to a publicly-held corporation, the conferees recommending this provision removed most of its bite by stating that practically "it may be difficult to establish [a tax avoidance] purpose in the case of a widely-held operating company when no individual or small group of individuals has legal or effective control of the company." See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 7-7 (7th ed. 2000) (quoting from H.R. REP. NO. 98-861, at 829 (1984), *reprinted in* 1984-3 C.B. (Vol. 2) 84); cf. *Technalysis Corp. v. Commissioner*, 101 T.C. 397, 410 (1993) (finding that the proscribed purpose did not exist despite earnings being accumulated beyond reasonable business needs, because the accumulation was not for the direct benefit of the shareholders).

⁹² See *supra* note 87 and accompanying text.

⁹³ That is, even if the U.S. subsidiary accumulates earnings beyond its reasonable business needs and the presumption of the proscribed purpose attaches, the subsidiary would appear to be able to demonstrate that its directors did not accumulate earnings with the intent to avoid the income tax on a minority of its foreign parent's shareholders. Cf. *Technalysis Corp.* 101 T.C. at 410 (examining the intent of the board of directors in determining whether a publicly-held corporation possessed the proscribed purpose, and finding to the contrary even though the corporation accumulated earnings beyond its reasonable business needs).

There is also the possibility that a U.S. subsidiary could face liability under the personal holding company tax for retaining excessive amounts of earnings.⁹⁴ For the personal holding company tax to apply, the U.S. subsidiary must meet a stock ownership test and an income test. The stock ownership test would be satisfied if more than fifty percent in value of the U.S. subsidiary's stock is owned by five or fewer individuals at any time during last half of the taxable year.⁹⁵ For purposes of determining stock ownership, attribution rules apply, so that the ownership test is applied to a U.S. subsidiary by looking to the ultimate individual owners of the foreign parent.⁹⁶ The income test would be met for a taxable year if at least sixty percent of the corporation's adjusted ordinary gross income consists of personal holding company income, which is generally investment income (including dividends, interest, certain royalties, and certain rents).⁹⁷ Because of the large proportion of investment income that is necessary to trigger the application of the tax, significant accumulations in the case of an operating company should be possible without the risk of penalty, even if the U.S. subsidiary cannot avoid satisfying the stock ownership test.⁹⁸

As a result of these rules, a typical U.S. subsidiary would appear to be able to accumulate a generous amount of earnings in nonbusiness assets and avoid both the dividend tax and the corporate penalty taxes for retaining earnings. On the other hand, a foreign corporation with a U.S. branch can avoid a branch profits tax on its U.S. branch earnings only to the extent that its U.S. net equity is increased.⁹⁹ Apart from the liability reduction election,¹⁰⁰ this would

⁹⁴ See I.R.C. §§ 541–547. Section 541 imposes a fifteen percent tax on the undistributed personal holding company income of a personal holding company (as defined in section 542). See I.R.C. § 541. Several types of corporations are excluded from the application of the personal holding company tax, including foreign corporations and banks. See I.R.C. § 542(c).

⁹⁵ See I.R.C. § 542(a)(2).

⁹⁶ See I.R.C. § 544(a).

⁹⁷ See I.R.C. §§ 542(a)(1), 543(b)(2), 543(a).

⁹⁸ Cf. BITTKER & EUSTICE, *supra* note 91, at 7-61 (suggesting an increase in the number of shareholders coupled with an avoidance of the stock attribution rules to avoid the personal holding company tax). However, corporations that meet the closely held test are cautioned to monitor their accumulation of earnings in investment assets. See Genz, *supra* note 61, at 138.

⁹⁹ See *supra* notes 38–43 and accompanying text. This assumes that the foreign corporation is not exempt from the application of section 884 by virtue of an income tax treaty. See *supra* note 36.

¹⁰⁰ See *supra* notes 68–71 and accompanying text.

require that the foreign corporation invest its U.S. earnings in U.S. assets, that is, assets that generally produce effectively connected income.¹⁰¹ This usually means that the assets must bear some connection to the business conducted by the U.S. branch.¹⁰² More specifically, U.S. assets include assets employed in U.S. business operations, such as real estate,¹⁰³ depreciable or amortizable personal property,¹⁰⁴ inventory,¹⁰⁵ income-producing U.S. real property that is elected for effectively connected treatment,¹⁰⁶ as well as financial assets (such as bank deposits and marketable securities) that produce effectively connected income.¹⁰⁷

¹⁰¹ See Treas. Reg. § 1.884-1(d) (1996). The regulations generally define U.S. assets as property held by the foreign corporation on the determination date (generally the close of taxable year), if all of the property's income and gain on that date is effectively connected income, or would be effectively connected if the property produced income and gain on that date. See Treas. Reg. § 1.884-1(d)(1)(i) (1996). In addition, the regulations employ effectively connected income rules and concepts to specify categories of property that qualify as U.S. assets regardless of the general rule. See Treas. Reg. § 1.884-1(d)(2)–(4) (1996).

¹⁰² See generally I.R.C. § 864(c); *infra* notes 103–38 and accompanying text. See also Mark Alan Masek, *United States Business: United States Branch Versus United States Corporation*, 23 INT'L LAW. 137 (1989).

¹⁰³ U.S. real estate used in U.S. business operations should qualify as a U.S. asset under the general rule contained in Treas. Reg. 1.884-1(d)(1)(i). See Treas. Reg. § 1.884-1(d)(2)(xi), ex. 2 (1996).

¹⁰⁴ All or a portion of depreciable or amortizable personal property used in U.S. business operations should qualify as a U.S. asset under a specific category rule. See Treas. Reg. § 1.884-1(d)(2)(i) (1996).

¹⁰⁵ All or a portion of inventory used in U.S. business operations should qualify as a U.S. asset under a specific category rule. See Treas. Reg. § 1.884-1(d)(2)(ii) (1996).

¹⁰⁶ Where a foreign corporation has made an election under section 882(d) to treat income from U.S. real property as effectively connected, the property should qualify as a U.S. asset under the general rule contained in Treas. Reg. 1.884-1(d)(1)(i). Cf. Treas. Reg. § 1.884-1(d)(2)(xi), ex. 3 (1996) (where a foreign corporation had not made an election under section 882(d), U.S. real property not connected to a U.S. business did not qualify as a U.S. asset).

¹⁰⁷ Specifically, financial assets would qualify as U.S. assets under the general rule if they meet the effectively connected income and gain standard contained therein. See *supra* note 101. In addition, certain categories of financial assets can qualify as U.S. assets under the specific category rules. An interest-bearing deposit with a bank or similar entity (e.g., savings and loans) would qualify as a U.S. asset if all of the income from the deposit during the year is effectively connected; a noninterest bearing deposit would qualify as a U.S. asset if the deposit is needed in the U.S. business under the asset-use test without regard to the presumption rule. See Treas. Reg. § 1.884-1(d)(2)(v) (1996); *infra* notes 111–16 and accompanying text. A debt instrument not covered under any other specific rule, such as a marketable

For U.S. source income from financial assets¹⁰⁸ to be effectively connected, either (i) the activities of the U.S. branch must be a material factor in the realization of the income,¹⁰⁹ in the case of income arising directly from U.S. branch activities,¹¹⁰ or (ii) the financial assets are used or held for use in the conduct of the U.S. branch's business,¹¹¹ in the case of income arising indirectly from U.S. branch activities.¹¹² The latter standard (referred to in the regulations as the "asset-use test") is satisfied if the asset is (a) "held for the principal purpose of promoting the present conduct" of the U.S. branch's business, (b) "acquired and held in the ordinary course of the [U.S.] trade or business," or (c) "otherwise held in a direct relationship" to that business.¹¹³ In determining whether an asset is held in a direct relationship to the U.S. business, a principal factor is whether the asset is needed in that business, which requires that the asset be held to meet the present needs of the U.S. business and not its anticipated future needs.¹¹⁴ In addition, an asset will be presumed to be held in a direct relationship to the U.S. business if (i) the asset was acquired with funds generated by that business, (ii) the income

security held by a nonbank, would qualify as a U.S. asset if (i) all of the income from the instrument for the taxable year is effectively connected and (ii) the yield on the instrument while it is held during the taxable year equals or exceeds the Applicable Federal Rate for obligations of similar type and maturity. See Treas. Reg. § 1.884-1(d)(2)(vi) (1996). Certain investment securities held by banks are treated as U.S. assets in proportion to the amount of their income that is treated as effectively connected for the taxable year. See Treas. Reg. § 1.884-1(d)(2)(vii) (1996); *infra* note 120 and accompanying text.

¹⁰⁸ Specifically, this refers to assets generating U.S. source FDAP income (e.g., interest, dividends, rents and royalties) and capital gains. See I.R.C. §§ 864(c)(2), 871(a)(1), (h), 881(a), (c).

¹⁰⁹ See I.R.C. § 864(c)(2)(B).

¹¹⁰ See Treas. Reg. § 1.864-4(c)(3), (c)(5) (2005). The regulations implementing this standard contain the business-activities test and the special banking rules. See *id.*

¹¹¹ See I.R.C. § 864(c)(2)(A). In making the determinations under section 864(c)(2), due regard is given to whether or not the asset or income is carried on books of account kept for the U.S. business. See I.R.C. § 864(c)(2); Treas. Reg. § 1.864-4(c)(4) (2005) (accounting test is not by itself controlling).

¹¹² See Treas. Reg. § 1.864-4(c)(2) (2005). Foreign source FDAP income generally cannot be effectively connected. See I.R.C. § 864(c)(4). One exception is where a U.S. banking branch derives interest or dividends on stocks or securities with respect to which the U.S. branch satisfies certain participation standards, among other requirements. See I.R.C. § 864(c)(4)(B)(ii); Treas. Reg. § 1.864-6(b)(2)(ii)(b) (1972); Treas. Reg. § 1.864-4(c)(5) (2005).

¹¹³ See Treas. Reg. § 1.864-4(c)(2)(ii) (2005).

¹¹⁴ See Treas. Reg. § 1.864-4(c)(2)(iv)(a) (2005).

from the asset is reinvested or retained in that business, and (iii) U.S. branch personnel significantly manage and control the investment of the asset.¹¹⁵ Generally, dividends and gain on stock cannot be effectively connected income under the asset-use test.¹¹⁶

Special rules apply to determine the effectively connected status of interest, dividends, and capital gains from securities or stocks derived by U.S. banking branches of foreign persons.¹¹⁷ Such banking income generally will be effectively connected if the U.S. banking branch actively and materially participated in soliciting, negotiating, or performing other activities necessary to arrange the acquisition of the security or stock.¹¹⁸ However, under these special banking rules, notwithstanding such participation, it would appear that income from stock usually cannot be effectively connected,¹¹⁹ and income on certain investment securities cannot be effectively connected to the extent that the aggregate of such securities exceeds ten percent of the assets of the U.S. branch.¹²⁰

¹¹⁵ See Treas. Reg. § 1.864-4(c)(2)(iv)(b) (2005).

¹¹⁶ See Treas. Reg. § 1.864-4(c)(2)(iii)(a) (2005). An exception applies for stock held by a foreign insurance company, unless the foreign insurance company owns ten percent or more of the vote or value of the stock in the particular corporation. See Treas. Reg. § 1.864-4(c)(2)(iii)(b) (2005).

¹¹⁷ See Treas. Reg. § 1.864-4(c)(5) (2005).

¹¹⁸ See Treas. Reg. § 1.864-4(c)(5)(ii), (iii) (2005).

¹¹⁹ This is a result of the requirement that stock be acquired (i) as a result of, or in the course of, making loans to the public, which excludes purchases on exchanges or over-the-counter markets, (ii) in the course of distributing stocks or securities to the public, or (iii) to satisfy reserve requirements established by banking authorities in the United States. See Treas. Reg. § 1.864-4(c)(5)(ii), (iv)(c) (2005). Compare Treas. Reg. § 1.864-4(c)(5)(vii), ex. 2 (2005) (dividends and gain on stock treated as not effectively connected where stock purchased on exchange and not acquired to meet reserve requirements) with Treas. Reg. § 1.864-4(c)(5)(vii), ex. 3 (2005) (dividends and gain on stock treated as effectively connected where stock received as consideration for making a loan).

¹²⁰ See Treas. Reg. § 1.864-4(c)(5)(ii) (2005). Specifically, securities that are covered by this rule are securities *other* than the following: (i) securities acquired (a) as a result of, or in the course of, making loans to the public, which excludes purchases on exchanges or over-the-counter markets, (b) in the course of distributing stocks or securities to the public, or (c) to satisfy reserve requirements established by banking authorities in the United States, or (ii) securities that (a) are payable on demand or at a fixed date one year or less from the acquisition date, or (b) issued by the United States government. See Treas. Reg. § 1.864-4(c)(5)(ii)(b)(3) (2005). An example of a security that would typically fall within this investment securities limitation would be a corporate bond, with a maturity date more than a year after the acquisition date, which is acquired on an exchange or organized over-the-counter market.

As a result of the rules for defining U.S. assets, a U.S. branch could be subject to a second-level tax where it invests its earnings in assets unrelated to its U.S. business, even though there would be no dividend tax (or likely corporate penalty taxes) in a similar situation involving a U.S. subsidiary.¹²¹ For example, the dividend tax obviously would not apply where a U.S. subsidiary, conducting a U.S. business that sells inventory, invests its earnings in U.S. corporate bonds, and neither the accumulated earnings tax nor the personal holding company tax would typically apply as well.¹²² In contrast, a foreign corporation with a U.S. sales branch may well face a branch profits tax liability in this situation (apart from the imputation of U.S. liabilities on additional U.S. assets¹²³). For the branch profits tax not to apply, the U.S. corporate bonds would need to qualify as U.S. assets, which, in turn, would require that interest on the bonds constitute effectively connected income.¹²⁴ Because the business activities of the U.S. branch do not give rise directly to the realization of the interest, the asset-use test should be used to determine the effectively connected status of the income.¹²⁵ Under this test, the interest income would be effectively connected if the bonds were held to meet the present needs of the U.S. business, such as if the bonds constituted a temporary investment of working capital.¹²⁶ On the other hand, the bonds ordinarily would not satisfy the asset-use test if they were held for future diversification into a new business, expansion of non-U.S. business activities, future business contingencies, or future plant replacement.¹²⁷

¹²¹ See Masek, *supra* note 102, at 144–45; cf. Musher, *supra* note 45, at 112–13 (pointing out that, under the assumption that the accumulated earnings tax would be potentially applicable to a comparable U.S. subsidiary, a U.S. branch apparently could not accumulate earnings in assets held for anticipated future business needs and avoid the branch profits tax, whereas a similarly situated subsidiary could do so and avoid the dividend tax as well as the accumulated earnings tax).

¹²² See *supra* notes 83–98 and accompanying text.

¹²³ See *supra* notes 55–60 and accompanying text.

¹²⁴ See *supra* note 107 and accompanying text. This assumes that the interest on the bonds equals or exceeds the Applicable Federal Rate for debt instruments with similar terms. See *id.*

¹²⁵ See *supra* notes 108–12 and accompanying text. In this regard, the regulations provide that the asset-use test is of primary significance where U.S. source interest income is derived by a foreign corporation that is engaged in the business of selling goods or manufacturing in the United States. See Treas. Reg. § 1.864-4(c)(2)(i) (2005).

¹²⁶ See Treas. Reg. § 1.864-4(c)(2)(iv)(a), (c)(2)(v), ex. 1 (2005).

¹²⁷ See Treas. Reg. § 1.864-4(c)(2)(iv)(a) (2005).

Nevertheless, the interest on the bonds may be effectively connected under the rule that presumes a direct relationship between the asset and the U.S. business, if the interest is reinvested or retained in the U.S. business and U.S. branch personnel significantly manage and control the investment in the bonds.¹²⁸ In this regard, it is not clear what constitutes reinvesting or retaining income in the U.S. business; while using the funds in the business activity of the U.S. branch should qualify,¹²⁹ retaining funds in an account or investment maintained by U.S. branch personnel may not.¹³⁰ Perhaps more significant is the uncertainty concerning the effect of the presumption. The regulations indicate that the taxpayer can overcome the presumption of a direct relationship by showing that the asset was held for future purposes relating to the U.S. business.¹³¹ It is unclear whether the Internal Revenue Service (Service) likewise can overcome the presumption by demonstrating such a purpose, and whether a party attempting to rebut the presumption needs to satisfy a higher than normal burden in order to prevail.¹³² It may be that the presumption merely shifts to the party opposed to effectively connected treatment the burden of showing that the asset was *not* held to meet the present needs of the U.S. business. If so, even if the presumption applies in the case of the bonds, the Service could still prevail in treating the bonds as non-U.S. assets by showing that they are held for purposes unrelated to the present needs of the U.S.

¹²⁸ See *supra* note 115 and accompanying text. The third requirement for the application of the presumption, that the asset was acquired with funds generated by the U.S. business, is satisfied under the assumed facts. See *supra* text accompanying note 122–23.

¹²⁹ This should include using income from the asset as working capital for the U.S. business, or to acquire property for use or sale in the U.S. business.

¹³⁰ An example in the regulations applying the presumption simply states that income from an asset is retained in the U.S. business without elaborating on the details. See Treas. Reg. § 1.864-4(c)(2)(v), ex. 2 (2005). Providing more detail, the House technical explanation of section 864(c)(2) states that the “significance to be attached to the disposition of the income [from an asset] will depend on the amount of such income and its relation to other activities of the U.S. business.” See H.R. REP. NO. 1450, 89TH CONG., 2D SESS., at 59 (1966), *reprinted in* 1966-2 C.B. 967, 1008. This statement indicates that simply retaining the income in an account maintained by the U.S. branch may not be sufficient to satisfy the presumption.

¹³¹ See Treas. Reg. § 1.864-4(c)(2)(v), ex. 2 (2005).

¹³² The regulations are silent in this regard. The proposed regulations under this section required a “clear showing” that the asset was not held to meet the present needs of the U.S. business in order to rebut the presumption. See Prop. Treas. Reg. § 1.864-4(c)(2)(iii)(b), 34 Fed. Reg. 1030, 1032 (Jan. 23, 1969).

business.¹³³

If the example above involved a U.S. branch engaged in banking, neither the asset-use test (with its presumption rule) nor the business activities test¹³⁴ would govern the effectively connected status of the interest on the bonds. Instead, the special banking rules would apply, and under these rules, the bonds generally would qualify as U.S. assets (because the interest income would be effectively connected) if the U.S. branch actively and materially participated in the acquisition of the bonds.¹³⁵ However, assuming that the bonds were purchased on exchanges (or organized over-the-counter markets) and had terms in excess of one year from the date of acquisition, the bonds likely would not qualify as U.S. assets to the extent that the aggregate of the bonds and similar securities held by the U.S. branch exceed ten percent of the assets of the U.S. branch.¹³⁶ As a result of the investment securities limitation, a U.S. banking branch would not have the same flexibility in retaining earnings as would a U.S. banking subsidiary, which could retain an unlimited amount of earnings in debt instruments of any type, including long-term corporate bonds and municipal government bonds (subject to possible constraints under the accumulated earnings tax¹³⁷). Nevertheless, a U.S. banking branch would appear to have a good deal of flexibility, given that it can retain earnings in U.S. government obligations and corporate bonds with maturity dates of one year or less from acquisition, without limitation under the investment securities rule.¹³⁸ In addition, a U.S. banking branch could retain earnings in other investment securities up to the

¹³³ On the other hand, the Service appears to indicate in a field service advice that it cannot rebut the presumption, characterizing the presumption rule as a safe harbor, which, if met by the taxpayer, will satisfy the direct relationship standard without a showing of actual need. See 1996 FSA LEXIS 273 (Jan. 30, 1996). The field service advice does not expressly discuss whether or not the Service could rebut a determination of direct relationship pursuant to the presumption rule. The legislative history of section 864(c), which gave rise to the presumption rule, does not appear to resolve the uncertainty. See H.R. REP. NO. 1450, *supra* note 130, at 1008 (“Generally, the presence of [the three presumption] factors is to be determinative of the assets being used in the business without showing that the income or assets are needed in the U.S. business.”).

¹³⁴ See *supra* notes 108–16 and accompanying text.

¹³⁵ See *supra* notes 117–18 and accompanying text.

¹³⁶ See *supra* note 120 and accompanying text.

¹³⁷ In this regard, the accumulated earnings tax likely would not be even potentially applicable to most U.S. subsidiaries of foreign corporations. See *supra* notes 83–93 and accompanying text.

¹³⁸ See *supra* note 120.

ten percent limit.

Even if foreign corporations with U.S. branches can use the asset-use test and the special banking rules to retain earnings in assets that are held for some investment or future business purposes, an important difference still exists between the branch and subsidiary settings: unlike a similarly situated U.S. subsidiary, a U.S. branch would lack certainty that the earnings will be treated as retained. While a U.S. subsidiary can retain earnings with near-certainty of avoiding a second-level tax simply by investing the earnings in assets owned by the subsidiary (with possible constraints under the personal holding company¹³⁹ and accumulated earnings taxes¹⁴⁰), a U.S. branch would need to satisfy the fact-specific standards under the effectively connected tests in order to increase (or maintain) its amount of U.S. assets.¹⁴¹ Consequently, a foreign corporation may inadvertently trigger a branch profits tax liability by making investments that do not qualify as U.S. assets,¹⁴² whereas a U.S. subsidiary should be able to control the imposition of second-level taxes with relative ease (subject to any constraints imposed by the corporate penalty taxes).¹⁴³ This difference may well add administrative costs to a U.S. branch, which must take the time and effort to ensure that it satisfies the proper standards to avoid a second-level tax.¹⁴⁴

¹³⁹ See *supra* note 94–98 and accompanying text.

¹⁴⁰ See *supra* notes 83–93 and accompanying text.

¹⁴¹ See *supra* notes 101–38 and accompanying text. Even with the apparent flexibility that U.S. banking branches have in retaining earnings, they still need to ensure that acquisitions of securities and stocks satisfy the active and material participation standard in order to have the assets qualify as U.S. assets. See *supra* notes 117–20 and accompanying text. In this regard, the Service has indicated that it will closely scrutinize situations where a foreign bank makes a loan to a related party. See Rev. Rul. 86-154, 1986-2 C.B. 103, 104 (situation 2). It is also possible for certain lending activities by a U.S. branch to give rise to securities subject to the investment securities limitation. For example, where a U.S. branch participates in a syndicated loan that is managed by another bank, if the U.S. branch acquires its participation interest after the initial funding of the loan, the interest would apparently fall within the investment securities limitation. See Reich, *supra* note 76, at 11–12. It is even possible for a related party loan involving material participation by the U.S. branch to be treated as a security not acquired in the course of making loans to the public, and therefore subject to the investment securities limitation. See *id.* at 12 n.25.

¹⁴² See Genz, *supra* note 61, at 135.

¹⁴³ See *id.*

¹⁴⁴ Cf. William H. Newton III, *Structuring Foreign Investment in United States Real Estate*, 50 U. MIAMI L. REV. 517, 524–25 (1996) (pointing out that avoiding the branch profits tax requires continuous monitoring of U.S. assets and liabilities, whereas avoiding the dividend tax only requires not making distributions).

C. Resulting Differences in the Imposition of Second-Level Taxes

Importantly, the ability on the part of a U.S. subsidiary to control the timing of the second-level tax goes beyond determining when the tax applies;¹⁴⁵ it can also affect *whether* a second-level tax is imposed. The repatriation of earnings upon the liquidation of a U.S. subsidiary of a foreign corporation is generally free of U.S. tax to the foreign parent.¹⁴⁶ Moreover, as discussed above, a U.S. subsidiary typically

¹⁴⁵ Of course, timing in itself can be important in light of the time value of money.

¹⁴⁶ It appears that section 332 generally would provide tax-free treatment to a foreign parent upon the liquidation of its U.S. subsidiary. Under section 332, a parent corporation generally will not recognize gain or loss upon the receipt of property in the complete liquidation of its subsidiary corporation provided that the parent owns at least eighty percent of the stock of the subsidiary (by vote and value) and the liquidation meets certain timing requirements. See I.R.C. § 332(a), (b). Section 367(a) generally provides that section 332 will not apply to the liquidation by a U.S. subsidiary into a foreign corporation. See I.R.C. § 367(a)(1). However, regulations under section 367(e)(2) make section 367(a) inapplicable to these outbound section 332 liquidations. See Treas. Reg. § 1.367(e)-2(a)(2) (2003); I.R.C. § 367(a)(6) (providing Treasury with the authority to exclude certain transfers from the application of section 367(a)(1)). Despite this clear statement of section 367(a)'s nonapplicability to outbound section 332 liquidations, there may be some question as to whether this statement applies for purposes of the foreign parent's tax treatment, given that the section 367(e) regulations are directed at the tax treatment of the liquidating subsidiary. Cf. Treas. Reg. § 1.367(e)-2(a)(1) (2003) (describing the purpose and scope of the section 367(e)(2) regulations). In the case of an outbound section 332 liquidation of a U.S. real property holding corporation (as defined in section 897(c)(2)), regulations under section 897(e) provide that the foreign parent will not recognize any gain under section 367(a) (or section 897(e)). See Temp. Treas. Reg. § 1.897-5T(b)(3)(iv)(A) (2003). Even if nonrecognition treatment would be unavailable under section 332 because of section 367(a), it is very likely that the foreign parent would still not be subject to tax on the recognized gain under sections 881 or 882. This is because the stock gains would not be FDAP income and therefore not subject to tax under section 881(a). See I.R.C. § 331(a); Treas. Reg. § 1.1441-2(b)(1), (2) (2000). And, pursuant to Treas. Reg. § 1.864-4(c), the stock gains would very likely not be effectively connected income and therefore not taxable under section 882(a). See *supra* note 116.

As an exception to this tax-free treatment, pursuant to recently added section 332(d), the liquidation of certain domestic holding companies can result in deemed dividends, which would generally be taxable to the foreign parent under section 881(a). More specifically, section 332(d) treats the liquidation of a U.S. corporation, substantially all of whose assets consist of stock of affiliated subsidiaries (under section 1504(a)), as a section 301 distribution to the foreign parent, if the liquidating U.S. corporation had been in existence for less than five years. As a result, the distribution would be treated as a dividend to the extent of the U.S. holding company's E&P, see I.R.C. §§ 301(c), 316(a), and thus subject to the thirty percent

would not be subject to the corporate penalty taxes for retaining earnings.¹⁴⁷ As a result, earnings retained by a U.S. subsidiary may never be subject to a second-level tax. The complete termination of a foreign corporation's U.S. branch generally is also tax-free,¹⁴⁸ in order to mirror the tax treatment of a liquidating U.S. subsidiary.¹⁴⁹

gross basis tax in the absence of treaty rate reduction. See I.R.C. § 881(a). Congress enacted the provision out of a concern that foreign corporations would establish a U.S. holding corporation to receive tax-free dividends from U.S. operating companies, liquidate the U.S. holding company to distribute the U.S. earnings without a dividend tax, and then reestablish another U.S. holding company. See S. REP. NO. 108-192, at 166 (2003). Thus, the provision limits the ability of foreign corporations with U.S. subsidiaries to avoid a dividend tax on U.S. earnings that are removed from the scope of net basis U.S. taxation prior to the cessation of U.S. operations. In this regard, see *infra* note 157-60 and accompanying text. The rules governing the complete termination of a foreign corporation's U.S. branch contain a similar restriction, in that the exemption from the branch profits tax for the year of termination is lost if, within three years after the termination, the foreign corporation has effectively connected income (with some exceptions) or the U.S. assets of the terminated branch (or property attributable to such U.S. assets or to effectively connected E&P of the termination year) are used by the foreign corporation or a related corporation in a U.S. business. See Temp. Treas. Reg. § 1.884-2T(a)(2) (1996); *infra* notes 148-49 and accompanying text; cf. S. REP. NO. 108-192, at 165-66 (2003) (referring to this branch termination rule in describing the present law in connection with proposal to add section 332(d)).

While the liquidation of a U.S. subsidiary generally is tax-free to the foreign parent, the U.S. subsidiary would generally be required to recognize any gain realized on the transaction. See *infra* note 149.

¹⁴⁷ See *supra* notes 83-98 and accompanying text.

¹⁴⁸ See Temp. Treas. Reg. § 1.884-2T(a)(1) (1996). A foreign corporation generally is not subject to the branch profits tax for the year in which it completely terminates its U.S. business activities. See *id.* The recapture tax is an exception to this complete termination rule. See *supra* note 71 and accompanying text. In general, a foreign corporation is treated as having completely terminated all of its U.S. business activities if (i) the foreign corporation has no U.S. assets; (ii) for the next three years, the foreign corporation has no effectively connected income (with some exceptions), and the U.S. assets of the terminated branch (as well as property attributable to such U.S. assets or to effectively connected E&P of the termination year) are not used by the foreign corporation or a related corporation in a U.S. business; and (iii) the foreign corporation satisfies certain procedural requirements. See Temp. Treas. Reg. § 1.884-2T(a)(2) (1996).

¹⁴⁹ See Feingold & Berg, *supra* note 46, at 223-26. Upon the liquidation of a U.S. subsidiary into its foreign parent, the subsidiary generally would be required to recognize realized gains (and permitted to recognize realized losses, subject to limitations) with respect to its assets that are distributed in the liquidation. See I.R.C. §§ 337(a), 367(e); Treas. Reg. § 1.367(e)-2(b)(1) (2003). An exception applies where distributed U.S. business assets continue to be used in a U.S. business by the foreign parent for the next ten years. See Treas. Reg. § 1.367(e)-2(b)(2)(i) (2003). However,

However, because a U.S. branch is less able to accumulate earnings,¹⁵⁰ and may be subject to the recapture rule with respect to a portion of its accumulated earnings,¹⁵¹ it is likely that less U.S. earnings will escape a second-level tax upon termination of a U.S. branch than upon liquidation of a U.S. subsidiary. Thus, the substantive differences between the branch profits tax and the dividend tax appear to be significant.

In part because the branch profits tax is more onerous than the dividend tax, commentators generally recommend that foreign corporations avoid conducting U.S. businesses in branch form and instead use U.S. subsidiaries.¹⁵² Thus, while the branch profits tax was

this exception would not be available in circumstances that are analogous to a foreign corporation's complete termination of its U.S. branch, because a U.S. business would no longer exist. Consequently, the liquidation of a similarly situated U.S. subsidiary would be a taxable event to the subsidiary. On the complete termination of a U.S. branch, a foreign corporation may well be disposing of its U.S. assets and thereby recognizing gains and losses on these assets. This is because the foreign corporation is required to have no U.S. assets in order to terminate completely its U.S. business. See Temp. Treas. Reg. § 1.884-2T(a)(2)(i)(A) (1996). However, it is also possible for a foreign corporation to convert a U.S. asset into a non-U.S. asset by repositioning the asset in a foreign business, although there are some limits on doing so as a result of sections 864(c)(6) and 864(c)(7). See *supra* notes 101–38 and accompanying text (discussion of U.S. assets); I.R.C. §§ 864(c)(6) (effectively connected status of deferred income is determined based on the underlying transaction), 864(c)(7) (property formerly used in a U.S. business and disposed of within ten years after cessation of such use will be treated as so used at the time of the disposition); cf. I.R.S. Priv. Let. Rul. 96-11-042 (Dec. 14, 1995) (regardless of whether foreign corporation continues to be engaged in a U.S. business, outstanding loans still constitute U.S. assets because interest income on the loans is effectively connected under section 864(c)(6) and any gain realized would be effectively connected under section 864(c)(7)). Even so, any gain on the disposition of a former U.S. asset apparently would be treated as effectively connected income if the asset is disposed of within ten years after its use in the U.S. business. See I.R.C. § 864(c)(7); see, e.g., I.R.S. Priv. Let. Rul. 200-018-027 (Feb. 1, 2000). Nevertheless, to bring about more similar treatment in the U.S. branch and subsidiary settings upon the termination of a U.S. business, consideration should be given to requiring a foreign corporation to recognize gains (and losses, with possible limits) where it converts U.S. assets to non-U.S. assets in the absence of a disposition.

¹⁵⁰ See *supra* Parts III.A and III.B.

¹⁵¹ See *supra* note 71 and accompanying text.

¹⁵² See Robert F. Hudson, Jr., *Current Techniques for Foreign Investment in U.S. Real Estate — Income and Estate Tax Considerations*, 22 TAX NOTES INT'L 3027, 3028, 3039 (2001); Hirschfeld & Grossman, *supra* note 18, at 38–39; Blessing, *supra* note 46, at 638 (listing other tax factors as well that favor the use of a U.S. subsidiary, including lack of statutory treating-shopping restrictions, ability to file consolidated returns, foreign corporate records being less relevant, and state income and franchise

aimed at reducing the disparity between the taxation of foreign corporations' U.S. branch and subsidiary operations by subjecting branch earnings to a second-level tax, as implemented the tax goes too far in this direction and thereby appears to discourage the use of branches.¹⁵³ The next Part explores certain measures for making the branch profits tax more like the dividend tax to effectuate Congress's desire for branch/subsidiary neutrality in imposing second-level taxes.

tax allocation formulas); Aaron A. Rubinstein & Angela W.Y. Yu, *The Benefits and Burdens of the Final Branch Level Taxes Regulations*, INT'L TAX J., Spring 1994, 58, 58–60 (branch profits tax regulations do not provide parity for U.S. subsidiaries and U.S. branches because the control of timing that exists for subsidiaries is lost for branches); cf. Genz, *supra* note 61, at 135–36 (pointing out that while there is no “cookie-cutter” analysis for determining whether to use a U.S. subsidiary or U.S. branch to conduct a U.S. business, the following factors have tended to create a preference for using a U.S. subsidiary: complexity of the branch tax rules, the difficulty in establishing qualified residency for claiming treaty benefits under the branch tax rules, the expense of compliance, and the fact that it is relatively easy for a U.S. subsidiary to control distributions (subject to corporate penalty tax constraints) whereas constructive remittances under the branch profits tax can occur quite unexpectedly); Lau & Auster, *supra* note 77, at 60–61 (noting that among other considerations, the complexity and burden of the branch level taxes have played a role in the traditional use of U.S. subsidiaries by foreign corporations doing business in the United States, but pointing out that with recent developments such as the check-the-box regulations, a single member LLC treated as a branch may provide greater tax benefits because of the ability to offset income in the foreign corporation's home country). An exception may exist where the foreign corporation has treaty protection against the branch profits tax. See Blessing, *supra* note 46, at 638. Another tax reason for preferring U.S. subsidiaries over U.S. branches may be the intricacies of the branch profits tax; avoiding the tax requires continuous monitoring of a foreign corporation's U.S. assets and liabilities, whereas avoiding the dividend tax merely requires refraining from making distributions. See Newton, *supra* note 144, at 524–25. The lack of guidance for attributing profits to branches for purposes of applying income tax treaties may also create a disincentive for using the branch structure. See Sprague, *supra* note 18, at 973.

¹⁵³ See Blessing, *supra* note 46, at 647 (concluding that the principal effect of the branch taxes appears to be that future U.S. operations generally will be conducted through U.S. subsidiaries, and that while Congress intended to achieve neutrality, the provision may discourage the use of branches by foreign corporations); Masek, *supra* note 102, at 145–46; cf. Groff & Hoch, *supra* note 55, at 368 (concluding that while the branch profits tax achieves parity with the taxation of U.S. subsidiaries in some respects, it may favor the use of U.S. subsidiaries by foreign banks in other respects).

IV. MODIFYING THE BRANCH PROFITS TAX TO MAKE IT MORE EQUIVALENT TO THE DIVIDEND TAX

A. Overview

As explained below, with certain modifications the branch profits tax would do a better job of effectuating Congress's intent to reduce the disparity in the taxation of U.S. branches and U.S. subsidiaries. Specifically, this Part suggests and examines two changes to the liability reduction election for making the branch profits tax more equivalent to the application of dividend tax in the subsidiary setting: (i) eliminating the potential for recapture upon the termination of a U.S. branch where a foreign corporation elects to reduce its U.S. liabilities, and (ii) removing the U.S. booked liability limitation under the election to reduce U.S. liabilities. This Part also examines a third, arguably more radical measure for bridging the gap between the branch profits and dividend taxes — providing foreign corporations with an election to treat investment assets generating U.S. source income as effectively connected assets — as well as a variation on this measure that is contingent on changes to the application of the accumulated earnings tax in the subsidiary setting.¹⁵⁴

The neutrality policy underlying the branch profits tax supports these measures for making the branch profits tax more equivalent to the dividend tax in the subsidiary setting.¹⁵⁵ With the corporate penalty taxes typically allowing for generous accumulations,¹⁵⁶ a foreign corporation using a U.S. subsidiary to conduct a U.S. business generally can avoid a second-level tax on the subsidiary's earnings by having the subsidiary invest the earnings in assets that it holds, or effectively doing the same by using the earnings to pay down its liabilities. Because the income generated by invested earnings will be subject to net basis taxation by the United States,¹⁵⁷ there will be a tax

¹⁵⁴ Some commentators have intimated an even more radical idea, in questioning whether it is sound policy to subject any U.S. source income to gross basis taxation in situations where a foreign person has U.S. business properties from which to collect taxes. See CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS 251 (2001). While this may be something to consider, this article proposes a more limited measure to advance neutrality in the application of second-level taxes. See *infra* Part IV.D.

¹⁵⁵ See *infra* Parts IV.B.1, IV.C.1, IV.D.1, and IV.E.2.

¹⁵⁶ See *supra* notes 83–98 and accompanying text.

¹⁵⁷ This is also effectively the case where earnings are used to pay down liabilities of the U.S. subsidiary, due to the resulting loss of interest deductions that would have been taken against the U.S. tax base.

cost to deferring or eliminating (if earnings are retained until liquidation¹⁵⁸) the second-level tax.¹⁵⁹ Consequently, a foreign corporation using a U.S. subsidiary to conduct a U.S. business usually has a choice of whether to incur a second-level tax or instead have the income on invested earnings continue to be taxed by the United States on a net basis. As explained in detail below, the measures proposed in this article allow for a similar result in the branch setting, and thus promote neutrality in the application of the branch profits and dividend taxes.¹⁶⁰

Besides the branch profits tax, concerns of branch/subsidiary neutrality are evident in several other features of international taxation, such as the deemed paid credit¹⁶¹ and the look-through rules under the foreign tax credit mechanism.¹⁶² Furthermore, eliminating disparities in the taxation of branches and subsidiaries is consistent with certain principles embodied in tax treaties. Treaty nondiscrimination articles generally require that a treaty country shall not tax a permanent establishment of a nonresident enterprise less favorably than a resident enterprise carrying on the same activities.¹⁶³ While many treaties now specifically exempt the U.S. branch profits tax from the ban on discriminatory taxes,¹⁶⁴ this appears to be predicated on Congress's view that the branch profits tax treats foreign corporations with U.S. branches no worse than the dividend tax treats foreign corporations with U.S. subsidiaries.¹⁶⁵ As explained

¹⁵⁸ See *supra* note 146 and accompanying text.

¹⁵⁹ See Blum, *supra* note 75, at 614–15.

¹⁶⁰ Cf. *id.* (stating that the branch profits tax imposes a second-level U.S. tax when U.S. branch earnings are reinvested outside the scope of net basis U.S. taxation, and that this makes the tax treatment of a U.S. branch closer to that of a U.S. subsidiary). Indeed, the tax treatment of the invested earnings appears to be the only relevant and sensible determinant in comparing distributions within a legal entity (the branch setting) to distributions between legal entities (the subsidiary setting). In fact, Congress appears to have recognized this, given that it intended for U.S. net equity under the branch profits tax to include only those assets and liabilities that generate income taxable by the United States on a net basis. See 1986 Bluebook, *supra* note 9, at 1040.

¹⁶¹ See I.R.C. § 902.

¹⁶² See I.R.C. § 904(d).

¹⁶³ See, e.g., MODEL CONVENTION, *supra* note 26, at art. 24, para. 2.

¹⁶⁴ See, e.g., MODEL CONVENTION, *supra* note 26, at art. 24, para. 5.

¹⁶⁵ See 1986 Bluebook, *supra* note 9, at 1038; S. REP. NO. 99-313, *supra* note 12, at 402; H.R. REP. NO. 99-426, *supra* note 12, at 433 (calling for Treasury to renegotiate outstanding treaties to permit the application of the branch profits tax).

above, however, this is not the case.¹⁶⁶ Indeed, the American Law Institute rejected an approach for implementing a branch remittance tax that would deem all branch earnings to have been remitted regardless of actual remittances, because of the concern that automatically subjecting a branch to an additional tax burden, when compared to a similarly-situated U.S. corporation, may well violate treaty nondiscrimination clauses.¹⁶⁷ Consequently, the principles, if not the current requirements, of treaty nondiscrimination articles also support measures for equalizing the application of second-level taxes with respect to branches and subsidiaries.

The measures suggested by this article, however, raise issues of potential conflicts with other policies governing the taxation of U.S. branches. In particular, as explained below, measures for eliminating substantive differences in the application of the branch profits tax and dividend tax may be at odds with the fungibility principle underlying the rules for imputing interest deductions to U.S. branch operations, as well as the policies supporting the effectively connected income rules.¹⁶⁸ There may also be the concern that these measures effectively repeal the branch profits tax or at least drastically minimize its effect.¹⁶⁹ However, an examination of these potential conflicts suggests that the measures are consistent with recognized policies governing the taxation of foreign corporations with U.S. branches.

*B. Eliminating the Recapture Rule Contained in the Election to
Reduce U.S. Liabilities*

1. Promoting Neutrality

The branch profits tax can be made more similar to a dividend tax by amending the liability reduction election so as to eliminate the resulting tax that can occur upon the termination of the U.S. branch. This measure would result in more neutral treatment of U.S. branches and U.S. subsidiaries, in that a reduction of U.S. liabilities under the election is analogous to a U.S. subsidiary's transfer of funds to its foreign parent to pay down inter-corporate debt, and funds used for this purpose will not be subject to a second-level U.S. tax upon the liquidation of the subsidiary.

¹⁶⁶ See *supra* Part III.

¹⁶⁷ See AMERICAN LAW INSTITUTE, *supra* note 21, at 144–45.

¹⁶⁸ See *infra* Parts IV.B.2 and IV.D.2.a.

¹⁶⁹ See *infra* notes 191–94, 253–59, 318–19 and accompanying text.

As discussed earlier, the regulations allow for an election to reduce U.S. liabilities for purposes of both determining U.S. net equity under the branch profits tax and calculating the U.S. branch's interest deduction under Treas. Reg. § 1.882-5, subject to the limitation that U.S. liabilities may not be reduced below the amount of U.S. booked liabilities.¹⁷⁰ However, the regulations generally provide that to the extent the foreign corporation does not ultimately make investments resulting in additional U.S. net equity in an amount equal to the earnings accumulating as a result of the election, the foreign corporation must recapture that amount as a dividend equivalent amount in the year that the U.S. branch is completely terminated.¹⁷¹

As indicated in the preamble to the final branch profits tax regulations, the election to reduce liabilities was intended to permit a foreign corporation to accumulate earnings in non-U.S. assets for later capital investment in the U.S. business.¹⁷² Even though the earnings are invested in non-U.S. assets, the earnings are shielded from the branch profits tax by the additional U.S. net equity resulting from the reduction in U.S. liabilities, at least until the termination of the U.S. branch. Consequently, the election essentially provides a foreign corporation with more time to make investments in U.S. assets in order to avoid the imposition of the branch profits tax.¹⁷³ While the accumulated earnings do not directly generate income subject to net basis U.S. tax (because they are not invested in U.S. assets), the loss of interest deductions resulting from reduced U.S. liabilities appears to be a surrogate for imposing U.S. tax on the income from these assets.¹⁷⁴

¹⁷⁰ See *supra* notes 68–70 and accompanying text.

¹⁷¹ See *supra* note 71–72 and accompanying text.

¹⁷² See T.D. 8432, 1992-2 C.B. 157, 159. In this regard, the liability reduction election replaced the expansion capital election contained in the proposed and temporary regulations, the latter being viewed by Treasury as ineffective and complex (if properly drafted) in permitting accumulations of expansion capital in what would otherwise be non-U.S. assets. See *id.*

¹⁷³ See Lau & Auster, *supra* note 77, at 41 n.13 (noting that the election to reduce liabilities effectively defers the branch profits tax). The liability reduction election can also result in a permanent elimination of the branch profits tax even where amounts are not ultimately invested in additional U.S. assets, if the election is made for a year in which there is positive current ECEP, but negative accumulated ECEP. See *supra* note 78.

¹⁷⁴ Cf. Lederman & Hirsh, *supra* note 73, at 113 n.13 (referring to the loss of interest deductions under the liability reduction election as comparable to the cost of the former expansion capital election, which required the investment yield on elected

Thus, the liability reduction election can produce an effect similar to the accumulation of earnings by a U.S. subsidiary of a foreign corporation, in that earnings can effectively be retained without the current imposition of a second level of U.S. tax. However, there are important differences in the functioning of this feature of the branch profits tax and a subsidiary's accumulation of earnings. A U.S. subsidiary of a foreign corporation avoids a dividend tax on its retained earnings, whether or not accumulated for business needs, and a second-level tax generally will not apply upon the liquidation of the subsidiary even if the earnings are never devoted to business needs.¹⁷⁵ Moreover, there appears to be little possibility that the accumulated earnings tax would apply on the retained earnings of the U.S. subsidiary as a surrogate for a second-level tax, and the personal holding company tax, even if potentially applicable, typically should still allow for generous accumulations without the risk of penalty.¹⁷⁶ On the other hand, the branch profits tax is generally imposed upon the termination of the U.S. branch if the accumulated earnings are not ultimately invested in U.S. assets, that is, assets that produce effectively connected income, which generally means that to permanently avoid the branch profits tax, the accumulated earnings ultimately must be invested in assets that bear some connection to the business conducted by the U.S. branch.¹⁷⁷ Moreover, additional U.S. assets are likely to give rise to additional U.S. liabilities;¹⁷⁸ consequently, a foreign corporation would probably need to increase its investment in U.S. assets by an amount that is considerably greater than the earnings accumulated pursuant to the liability reduction election in order to avoid a branch profits tax upon termination of the U.S. branch.¹⁷⁹ As a result, these features make the imposition of the branch profits tax more likely than the imposition of second-level taxes in the subsidiary setting.¹⁸⁰

securities to be included as effectively connected income). The cost of reducing liabilities may be offset to an extent by a resulting reduction in excess interest tax liability. See *supra* note 74 and accompanying text.

¹⁷⁵ See *supra* notes 81–82, 146 and accompanying text.

¹⁷⁶ See *supra* notes 83–98 and accompanying text.

¹⁷⁷ See *supra* notes 101–38 and accompanying text. See *supra* note 78 and accompanying text for a situation where the tax can be avoided even without a subsequent investment in U.S. assets.

¹⁷⁸ See *supra* notes 43, 56–60 and accompanying text.

¹⁷⁹ See *supra* notes 71–72 and accompanying text.

¹⁸⁰ It is not clear whether Treasury was aware of this difference when drafting the regulations. Treasury included the recapture rule out of concern that repeated liability reduction elections could result in substantial deferral of branch profits tax

There is, however, a more fundamental problem with the current liability reduction election in light of the neutrality policy underlying the branch profits tax. The recapture rule contained in the provision results in dissimilar treatment for foreign corporations with U.S. branches versus those with U.S. subsidiaries because a reduction of U.S. liabilities under the election is analogous to a U.S. subsidiary's transfer of funds to its foreign parent to pay down inter-corporate debt, and funds used for this purpose will not be subject to a second-level U.S. tax upon the liquidation of the subsidiary.

The amount of liabilities subject to reduction in the U.S. branch setting, i.e., the excess of U.S. liabilities over U.S. booked liabilities, is analogous to debt owed by a U.S. subsidiary to its foreign parent.¹⁸¹ Thus, where a foreign corporation elects to reduce its U.S. liabilities to eliminate or reduce a dividend equivalent amount, the appropriate analogy in the U.S. subsidiary setting is the subsidiary's use of funds to satisfy liabilities owed to its foreign parent. Upon a pay down of inter-corporate liabilities in the subsidiary setting, funds earned by the

liability, as well as its elimination upon the complete termination of the U.S. branch under Temp. Treas. Reg. § 1.884-2T(a). See *Genz, supra* note 61, at 134. Thus, Treasury concluded that accumulated earnings resulting from reductions in U.S. liabilities ultimately had to be invested in U.S. assets, or else the branch profits tax would eventually be imposed on the accumulated earnings. Perhaps Treasury was under the impression that the accumulated earnings tax would be potentially applicable in all cases involving U.S. subsidiaries of foreign corporations; what is apparently the first in a series of private letter rulings taking the opposite view was issued the same year that the final regulations were promulgated, although the regulation that the ruling applied had been issued in 1959. See T.D. 6377, 1959-1 C.B. 125; *supra* note 88 and accompanying text. Or perhaps Treasury thought that with the possible reduction in excess interest tax liability, the loss of interest deductions pursuant to the election was not a sufficient surrogate for taxing the income generated by the accumulated earnings. However, the foreign corporations that are in a position to use the election may well have a minimal reduction in excess interest tax liability as a result of the election. See *supra* note 74. It is possible that Treasury felt compelled by the statute and legislative history to give the branch profits tax some real "teeth," despite the resulting differences when compared to the application of second-level taxes in the subsidiary setting. However, the statute and legislative history give Treasury latitude in defining U.S. assets and U.S. liabilities, provided these definitions are consistent with those used to determine assets and liabilities that give rise to effectively connected taxable income. See I.R.C. § 884(c)(2); 1986 Bluebook, *supra* note 9, at 1040. And by crafting the recapture rule, Treasury is not taking into account the policy of branch/subsidiary neutrality that underlies the branch profits tax. See *infra* notes 181-90 and accompanying text for a discussion of a more fundamental problem with the recapture rule.

¹⁸¹ This is the conceptualization for the branch level tax on excess interest contained in section 884(f)(1)(B). See *supra* notes 50-52 and accompanying text.

U.S. subsidiary can be invested in assets whose income will not be subject to U.S. net basis taxation, yet without a dividend tax on the transferred amounts.¹⁸² Similarly, in the branch setting, the liability reduction election allows funds earned through U.S. branch operations to be invested in noneffectively connected assets, free of a current branch profits tax. And in both settings, the events result in fewer liabilities for determining interest deductions taken against the U.S. tax base. To this extent neutrality is achieved — a U.S. branch has the same opportunity as a U.S. subsidiary to shift funds outside of the United States without incurring a current second-level tax, by reducing the amount of liabilities that are taken into account for U.S. tax purposes.

However, unlike what occurs under the branch profits tax because of the recapture rule, funds earned by the U.S. subsidiary that are used to pay down inter-corporate debt will not be subject to a second level of U.S. tax upon the liquidation of the subsidiary.¹⁸³ There is no

¹⁸² Upon the repayment of a loan made by a foreign parent to its U.S. subsidiary, the parent would not have any gross income, assuming the payment equaled the parent's adjusted basis in the debt instrument. See I.R.C. §§ 1001, 1271(a). Consequently, there generally should be no FDAP income for purposes of section 881(a) on the repayment of the loan. See Treas. Reg. § 1.1441-2(b)(1) (2000) (noting that FDAP income requires that there be gross income). Nevertheless, there is the possibility that debt could be reclassified as stock for tax purposes if, for example, the U.S. subsidiary is thinly capitalized. See generally BITTKER & EUSTICE, *supra* note 91, at 4-41 to -53. If that were to occur, the repayment of the debt would be treated as a redemption of stock that would be taxable to the foreign parent as a dividend (to the extent of the subsidiary's E&P). See I.R.C. §§ 302(b), (d), 301(c), 316(a), 881(a); BITTKER & EUSTICE, *supra* note 91, at 4-57 (pointing out that the repayment of a purported loan that is reclassified as equity would be treated as a stock redemption, with the substantial risk of being taxed as a dividend). It should be noted that there is also the potential for debt/equity reclassification in the case of a foreign corporation with a U.S. branch. Under Treas. Reg. § 1.882-5, the Service has the ability to reclassify a foreign corporation's purported debt as equity for purposes of determining the foreign corporation's actual liability-to-asset ratio, which is used to impute liabilities to the U.S. branch (if the foreign corporation elects to use its actual ratio). See Treas. Reg. § 1.882-5(c)(2)(ii), (c)(5), ex. 1 (1996); *supra* note 43. If reclassification were to occur in the branch setting, U.S. liabilities would be reduced. To bring about similar consequences for U.S. branches and subsidiaries upon reclassification, consideration should be given to disregarding an elective reduction of U.S. liabilities to the extent that U.S. liabilities have been reduced as a result of debt/equity reclassification. With this approach, reclassification in the branch setting could produce a dividend equivalent amount, which would be analogous to the dividend consequences upon reclassification in the subsidiary setting.

¹⁸³ Moreover, even though the pay down of inter-corporate liabilities would not reduce E&P, the earnings represented by the transferred funds would never be

recapture of these amounts as a dividend upon liquidation, regardless of whether there are subsequent infusions of assets into the subsidiary. For example, assume that a foreign corporation initially capitalizes its wholly owned U.S. subsidiary with \$1,000,000 of assets, taking back \$500,000 of stock and \$500,000 of debt. In its first year of operations, the subsidiary has \$500,000 of earnings and profits and uses these funds to pay off the \$500,000 liability owed to its foreign parent.¹⁸⁴ The next year the U.S. subsidiary liquidates. The liquidating distribution of assets should be tax-free to the foreign parent.¹⁸⁵

In comparison, assume that a foreign corporation establishes a U.S. branch by investing \$1,000,000 in effectively connected assets, with \$500,000 of liabilities imputed to the U.S. branch pursuant to Treas. Reg. § 1.882-5. In its first year of operations, the U.S. branch has \$500,000 of effectively connected E&P. The foreign corporation does not invest any of its U.S. earnings in effectively connected assets, but elects to reduce its U.S. liabilities to zero, resulting in a dividend equivalent amount of zero for the year.¹⁸⁶ The next year the foreign corporation completely terminates the U.S. branch. While generally tax-free,¹⁸⁷ the complete termination of the U.S. branch in this case results in a \$500,000 dividend equivalent amount under the recapture rule, given that the foreign corporation had elected to reduce its U.S. liabilities and did not (prior to the year of the complete termination) increase its investment in U.S. net equity by an amount equal to the effectively connected E&P that accumulated as a result of the liability

subject to a dividend tax provided that subsequent nonliquidating distributions by the subsidiary do not exceed subsequent E&P. Furthermore, there appears to be little possibility that the subsidiary would be subject to the corporate penalty taxes on these earnings. *See supra* notes 83–98 and accompanying text. Even in the atypical case where the accumulated earnings tax would be potentially applicable, the tax should not apply if, after paying down inter-corporate liabilities, the subsidiary's remaining assets consist of operating assets and other assets held for the reasonable needs of its business (which should be the case where the funds originally borrowed from the foreign parent were used for this purpose). *Cf. infra* note 312. Under these facts, the personal holding company tax also is not likely to apply. *Cf. supra* notes 94–98 and accompanying text.

¹⁸⁴ The repayment of the loan generally should be tax-free to the foreign parent. *See supra* note 182.

¹⁸⁵ *See supra* note 146 and accompanying text.

¹⁸⁶ In light of the U.S. booked liability limitation on reducing liabilities, it is assumed that the foreign corporation has U.S. booked liabilities of zero, thereby allowing U.S. liabilities to be reduced to zero.

¹⁸⁷ *See supra* note 148 and accompanying text.

reduction election.¹⁸⁸

While there are certainly legal differences between the reduction of liabilities imputed to a U.S. branch for tax purposes and a U.S. subsidiary's pay down of liabilities owed to its foreign parent, the branch profits tax is concerned purely with the tax consequences of transactions as opposed to their legal consequences. For example, a remittance of funds within a single foreign corporation should have no legal consequences, yet this transaction can clearly result in branch profits tax liability for the particular year.¹⁸⁹ Thus, in evaluating the branch profits tax in terms of neutrality, it is appropriate to consider the tax consequences of the reduction of liabilities in the branch and subsidiary settings despite the legal differences involved. This analysis indicates that eliminating the recapture rule would promote tax neutrality in the application of second-level taxes with regard to U.S. branches and U.S. subsidiaries.¹⁹⁰

It may be contended that without the recapture rule, foreign corporations would often make the election to reduce their U.S. liabilities,¹⁹¹ resulting in lower dividend equivalent amounts with no

¹⁸⁸ See *supra* note 71.

¹⁸⁹ See *supra* notes 35–44 and accompanying text.

¹⁹⁰ Besides the recapture tax in the branch setting, another difference in the two situations analyzed above is that the foreign corporation would likely include the amount by which it reduced its U.S. liabilities as part of its U.S.-connected liabilities for purposes of determining its interest deduction for the year of complete termination. This is because the election to reduce U.S. liabilities is done annually (see *supra* note 70), and the foreign corporation would have no need to reduce its U.S. liabilities for the year of complete termination given that the branch profits tax would not apply for this year (aside from the recapture rule), see Temp. Treas. Reg. § 1.884-2T(a)(1) (2006), unless it did so to reduce its excess interest tax exposure for that year. In contrast, a U.S. subsidiary would not receive interest deductions for the year of liquidation on the amount by which it reduced its liabilities. Consequently, so that U.S. branches do not receive an advantage over U.S. subsidiaries in this regard, with the elimination of the recapture rule, I recommend that the amount of U.S.-connected liabilities for the year of complete termination be reduced by the amount of the liability reduction for the previous year, regardless of whether the election is continued for the year of complete termination.

In commenting on the temporary and proposed branch profits tax regulations, commentators have similarly proposed allowing foreign corporations to reduce the amount of liabilities imputed to U.S. branches (and without any mention of the need for a recapture rule upon termination of the U.S. branch), in order to promote neutrality for U.S. branches and subsidiaries. See *Peat Marwick Comments, supra* note 16 (proposing that liabilities not be imputed to investment assets that are elected to be treated as effectively connected assets); *Institute of International Bankers Comments, supra* note 16.

¹⁹¹ However, even without the recapture rule, there may be reasons why foreign

restoration of these amounts upon the termination of the U.S. branch. Thus, the elimination of the recapture rule may significantly reduce the amount of tax imposed under Code section 884(a). However, there are limits on a foreign corporation's ability to lower its annual dividend equivalent amount by reducing U.S. liabilities, given the U.S. booked liability limitation.¹⁹² Consequently, significant exposure to the section 884(a) tax is possible even with a liability reduction election that can permanently eliminate a portion of the branch profits tax liability. More importantly, the election to reduce U.S. liabilities would carry with it a cost — the loss of interest deductions for purposes of determining effectively connected taxable income.¹⁹³ Consequently, the branch profits tax would continue to affect, albeit indirectly, the U.S. tax liability of foreign corporations' U.S. branch operations, and to the same extent that the dividend tax affects similarly situated U.S. subsidiaries. That is, for both U.S. branches and U.S. subsidiaries, second-level taxes can be avoided only at the cost of having the income generated by the invested earnings subject to net basis taxation by the United States, which is effectively the case with the loss of interest deductions.¹⁹⁴

2. Potential Conflict with the Policies Supporting the Fungibility Approach for Imputing Liabilities

While advancing neutrality, the elimination of the recapture rule may violate the policies supporting the fungibility approach for imputing liabilities to U.S. branches. However, while this measure would allow a foreign corporation to reduce the liability-to-asset ratio of its U.S. branch below that of the foreign corporation as a whole (or, alternatively, below a fixed ratio),¹⁹⁵ a ceiling on a U.S. branch's

corporations would refrain from electing to reduce liabilities. *See supra* note 75.

¹⁹² *See supra* note 69 and accompanying text.

¹⁹³ This is mitigated to a degree by the possible reduction in excess interest tax liability. *See supra* note 74 and accompanying text.

¹⁹⁴ In terms of the previous examples, the \$500,000 of U.S. earnings will effectively generate income subject to U.S. net basis taxation. That is, prior to the realization of these earnings, there was \$500,000 of net assets (\$1,000,000 of assets less \$500,000 of liabilities) generating taxable income subject to U.S. tax. After the realization of the earnings and reduction of liabilities, there are \$1,000,000 of net assets (\$1,000,000 of assets less \$0 liabilities) generating taxable income subject to U.S. tax.

¹⁹⁵ As mentioned previously and amplified below, with the recapture rule, the current liability reduction election really represents a deferred imposition of the branch profits tax rather than an actual deviation from the fungibility approach. *See*

liability-to-asset ratio would remain, thus continuing to address the thin capitalization concerns underlying the fungibility approach.

As discussed previously, Treas. Reg. § 1.882-5, which implements the fungibility approach for determining interest deductions, imputes liabilities to the U.S. branch in an amount equal to the amount of U.S. assets multiplied by either the foreign corporation's actual worldwide liability-to-asset ratio or a fixed ratio.¹⁹⁶ By giving a foreign corporation the flexibility to reduce its U.S. branch liability-to-asset ratio below the prescribed ratio, the suggested measure arguably conflicts with the fungibility approach governing the amount of capital allocated to U.S. branches. Of course, given that the current election permits a foreign corporation to reduce its U.S.-connected liabilities below the amount calculated under Treas. Reg. § 1.882-5, the elimination of the recapture component of the current election may be viewed as resulting in no greater deviation from the fungibility concept. However, because of the potential for recapture, the election to reduce liabilities effectively results in the delayed remittance of U.S. earnings that are not ultimately invested in U.S. assets, as opposed to a decrease in the liability-to-asset ratio of U.S. branch.¹⁹⁷ The resulting loss of interest deductions apparently represents a surrogate for imposing U.S. tax on the income from the investment in non-U.S. assets.¹⁹⁸ Without recapture, however, we understand the foreign corporation to be using funds earned through U.S. branch operations to satisfy constructive inter-branch liabilities, thereby running counter to the fungibility approach for allocating liabilities and capital to U.S. branches of foreign corporations.

While an election to reduce liabilities without the recapture rule arguably offends the fungibility concept, it does not violate what appears to be the key policy underlying fungibility: ensuring that a U.S. branch has an *adequate* amount of *capital* for tax purposes. In establishing the fungibility approach for allocating interest deductions, it appears that Treasury was mainly concerned with the ability of taxpayers to manipulate the tax results under a booking approach for determining branch liabilities.¹⁹⁹ For example, under a booking

supra notes 172–74 and accompanying text; *infra* notes 197–98 and accompanying text.

¹⁹⁶ See *supra* note 43.

¹⁹⁷ See *supra* notes 172–73 and accompanying text.

¹⁹⁸ See *supra* note 174 and accompanying text.

¹⁹⁹ Cf. Treas. Reg. § 1.861-9T(a) (2004) (stating that the “fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds”); 1986 Bluebook, *supra* note

approach, a taxpayer would be able to allocate interest deductions to effectively connected income, and thus reduce the U.S. tax base, simply by having liabilities booked at the U.S. branch. Thus, the fungibility approach was apparently aimed at addressing the concern of having an *excessive* amount of liabilities and interest expense allocated to U.S. activities.²⁰⁰ Similarly, under the separate entity approach for taxing branch operations, which is supported by the OECD as well as authorized under some U.S. tax treaties,²⁰¹ the concern is whether the branch has too little capital, not too much.²⁰² That the real concern is preventing excessive amounts of liabilities is further borne out by the fact that Treas. Reg. § 1.882-5 uses a modified fungibility approach which permits a foreign corporation, for administrative reasons, to use a fixed liability-to-asset ratio.²⁰³ The use

9, at 944 (describing how taxpayers could use a strict separate company method to allocate interest expense against foreign source income by adjusting the location of borrowing within an affiliated group).

²⁰⁰ Cf. *Nat'l Westminster Bank, PLC v. United States*, 44 Fed. Cl. 120 (1999) (stating the government's position that the fungibility approach contained in Treas. Reg. § 1.882-5 serves as a simple yet effective means of allocating capital to U.S. branches and preventing manipulation to shift income for tax avoidance purposes); I.R.S. Notice 2005-53, 2005-32 IRB 263, 263 (Aug. 8, 2005) (stating that Treasury and the Service continue to believe that Treas. Reg. § 1.882-5 results in a sufficient allocation of equity capital to a permanent establishment while addressing the effect of the recent treaties with the United Kingdom and Japan on its application).

²⁰¹ See Convention Between the Government of the United States of America and the Government of Japan For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, U.S.-Japan, art. 7, Nov. 6, 2003, S. TREATY DOC. NO. 108-14 (2003); Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 7, July 24, 2001, S. TREATY DOC. NO. 107-19 (2002).

²⁰² See *U.S. Treasury Releases Technical Explanation of Japan-U.S. Tax Treaty*, WORLDWIDE TAX DAILY (Feb. 25, 2004) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2004 WTD 39-11) (part 1 of 2) (pointing out "that a permanent establishment cannot be funded entirely by debt, but must have sufficient capital to carry on its activities" in the course of explaining Article 7, paragraph 3, as interpreted by diplomatic notes); *U.S. Treasury Department Releases Technical Explanation of Proposed U.K.-U.S. Income Tax Treaty and Protocol*, WORLDWIDE TAX DAILY (Mar. 5, 2003) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2003 WTD 45-27) (part 1 of 2) (same); Molly Moses, *IRS Official Responds to Comments on OECD Paper for PE Profit Attribution*, 2004 BNA DAILY TAX REP. No. 89, at G-4 (May 10, 2004) (stating that the basic concept underlying the OECD method of allocating capital is that the permanent establishment should have sufficient capital to support its functions and risks). See generally *Nat'l Westminster Bank, PLC v. United States*, 58 Fed. Cl. 491 (2003).

²⁰³ See *supra* note 43.

of the fixed ratio by electing foreign corporations offends pure fungibility, given that the liability ratio of the U.S. branch will deviate from that of the entire corporation.²⁰⁴ However, as with the use of the fixed liability ratio, elimination of the recapture rule would still result in a cap on the liabilities attributed to the U.S. branch. Consequently, providing foreign corporations with the flexibility to increase the capital of their U.S. branches for tax purposes is not inconsistent with the central policy underlying the fungibility approach.²⁰⁵

C. Removing the U.S. Booked Liability Limitation Under the Election to Reduce U.S. Liabilities

1. Promoting Neutrality

Tax neutrality between U.S. branches and subsidiaries would be advanced by permitting a foreign corporation to lower its dividend equivalent amount by reducing its U.S. liabilities below the amount of U.S. booked liabilities. This is because such a further reduction in U.S. liabilities is analogous to a foreign parent's assumption of third party liabilities of its U.S. subsidiary in connection with the transfer of funds by the subsidiary to the parent. This type of transaction is not subject to a dividend tax.

As discussed earlier, in allowing for the liability reduction election, the regulations prohibit a foreign corporation from reducing its U.S. liabilities below the amount of U.S. booked liabilities.²⁰⁶ Even with the liability reduction election as a way of permitting the accumulation of earnings for later capital investment in the U.S.

²⁰⁴ Alternatively, the use of the fixed ratio may indicate that Treasury views the administrative benefits of avoiding the calculation (and verification) of an actual liability-to-asset ratio as outweighing any benefits derived from using a pure fungibility of liabilities approach. The same can be said about the neutrality benefits of eliminating the recapture rule.

²⁰⁵ As far as another potential policy conflict, it may be pointed out that lessening the impact of the branch profits tax may substantially benefit foreign financial institutions and insurance companies, who, unlike other foreign corporations, often prefer to structure their U.S. operations as branches for nontax reasons. See John O. Hatab, *U.S. Taxation of Foreign Banking in the United States – An Overview*, 41 N.Y.U. ANN. INST. ON FED. TAX'N 27.01[1], at 27-2 (1983); Rubinstein & Yu, *supra* note 152, at 58–59; Henry J. Birnkrant et al., *Prop. Reg. 1.882-5 Overhauls Interest Allocation for U.S. Branches*, 3 J. INT'L TAX'N 166, 166 (1992). However, there is no indication that Congress enacted the branch profits tax in order to exact a heavier tax toll on foreign corporations engaged in banking or insurance businesses, as compared to other foreign-controlled U.S. businesses.

²⁰⁶ See *supra* note 69 and accompanying text.

business, there is not an obvious need for imposing such a limit on reducing liabilities.²⁰⁷ While a greater amount of earnings could be temporarily invested in non-U.S. assets without a current branch profits tax liability in the absence of such a limit, there would also be increased costs, as reducing U.S. liabilities below the amount of U.S. booked liabilities would result in a greater loss of interest deductions for U.S. tax purposes. Perhaps Treasury felt that for purposes of determining interest deductions, U.S. booked liabilities “belong” to the U.S. branch to a greater extent than the excess of U.S. liabilities over U.S. booked liabilities, and that therefore a foreign corporation should not be permitted to reduce U.S. liabilities below this amount.²⁰⁸ However, the key determinant in computing a foreign corporation’s interest deductions is the amount of U.S.-connected liabilities, not U.S. booked liabilities. While the interest rate on U.S. booked liabilities is used to impute interest expense to U.S.-connected liabilities (to the extent of U.S. booked liabilities) under the adjusted U.S. booked liabilities method,²⁰⁹ the regulations effectively remove a portion of U.S. booked liabilities from the computation to the extent that U.S.-connected liabilities are less than U.S. booked liabilities. This removal is performed by multiplying the interest expense on U.S. booked liabilities by the ratio of U.S.-connected liabilities to U.S. booked liabilities.²¹⁰ Consequently, U.S. booked liabilities should not

²⁰⁷ In this regard, the preamble to the final regulations adopting the liability reduction election is silent as to the reasons for the U.S. booked liability limitation. See T.D. 8432, 1992-2 C.B. 157.

²⁰⁸ This view may be indicated by the fact that the floor for reducing U.S. liabilities also includes liabilities that are directly allocable to U.S. assets under Temp. Treas. Reg. § 1.861-10T, which, like U.S. booked liabilities, appear to bear a stronger connection to the operations of the U.S. branches as compared to other liabilities of the foreign corporation. See *supra* note 69; Temp. Treas. Reg. § 1.861-10T (1988).

²⁰⁹ This is the effect of the adjusted U.S. booked liability method. When U.S.-connected liabilities exceed U.S. booked liabilities, the interest deduction allocable to effectively connected income is the total of the interest paid or accrued by the U.S. branch on U.S. booked liabilities, plus the excess of U.S.-connected liabilities over U.S. booked liabilities multiplied by the foreign corporation’s interest rate on U.S.-dollar liabilities that are booked outside the United States; when U.S. booked liabilities exceed U.S.-connected liabilities, the interest deduction allocable to effectively connected income is the interest paid or accrued by the U.S. branch on U.S. booked liabilities, multiplied by the ratio of U.S.-connected liabilities to U.S. booked liabilities. See Treas. Reg. § 1.882-5(d)(4), (d)(5) (1996). See generally *supra* note 43.

²¹⁰ See *supra* note 209. Moreover, the amount of U.S. booked liabilities is not relevant under the current separate currency pools method. See Treas. Reg. § 1.882-5(e) (1996). It should be noted that the previous version of the separate currency

be viewed as sacred for purposes of the interest expense determination.²¹¹ Alternatively, the liability reduction limit may simply have been intended as a lower cap (as compared to the amount of U.S. liabilities) on the ability to accumulate earnings for later capital investment in U.S. assets. The Treasury may have felt that such a limit, although not mandated by the theory underlying the election, was appropriate given that the statute does not appear to call for any flexibility in the timing of the tax.²¹²

In any event, the limit on the liability reduction election runs counter to the neutrality concerns underlying the branch profits tax, in that it results in disparate tax treatment for similarly-situated U.S. branches and subsidiaries. The limit on the election applies in the situation where the amount of U.S. booked liabilities equals or exceeds the amount of U.S. liabilities. Where U.S. booked liabilities exceed U.S. liabilities, a foreign corporation can be regarded as having borrowed amounts in the United States to fund activities of its foreign branches.²¹³ This situation is analogous to a U.S. subsidiary with no borrowings from its foreign parent and with total liabilities that are less than the combined third-party U.S. booked liabilities of the parent and the subsidiary. In other words, in this situation a portion of the third-party U.S. booked liabilities is considered a liability of the foreign parent rather than of the U.S. subsidiary. Where U.S. booked

pools method, which was in effect when Treasury promulgated the branch profits tax regulations, did use the denominations of U.S. booked liabilities in determining the currency pools to which the method applied. *See* former Treas. Reg. § 1.882-5(b)(3)(ii) (1981).

²¹¹ Another possible reason for the U.S. booked liability limitation is that Treasury may have conceptualized the liability reduction election as if the branch, as a hypothetical U.S. subsidiary, were paying down liabilities owed to its foreign parent, and that this construct only applies to the excess of U.S. liabilities over U.S. booked liabilities. This is the concept that I have advanced for the current liability reduction election. *See supra* notes 181–82 and accompanying text. Such a construct, however, is inconsistent with the recapture rule. *See supra* notes 183–90 and accompanying text. Thus, it appears that, as stated in the preamble to the final regulations, Treasury crafted the liability reduction election as a means of permitting a foreign corporation to accumulate expansion capital, as opposed to implementing a construct that involves the pay down of inter-corporate liabilities. In any event, the application of the latter construct with respect to third party liabilities supports the elimination of the U.S. booked liability limitation. *See infra* notes 213–21 and accompanying text.

²¹² In this regard, there were fairly stringent limits on treating marketable securities as effectively connected under the former expansion capital election, the prior regulatory mechanism for accumulating expansion capital. *See infra* note 240.

²¹³ *See* Jessica L. Katz & Charles T. Plambeck, *U.S. Income Taxation of Foreign Corporations*, 908 T.M. (BNA) A-25 (2000).

liabilities exceed U.S. liabilities, a reduction in U.S. liabilities to lower a dividend equivalent amount²¹⁴ is analogous to a transfer of funds by the subsidiary to the parent in connection with the parent assuming an additional portion of the third-party liabilities equal to the reduction in U.S. liabilities.²¹⁵ This is because in both the branch and subsidiary settings, funds generated by U.S. operations would be invested in assets whose income is not subject to U.S. net basis taxation,²¹⁶ with a reduction in the amount of liabilities for determining the interest expense deduction taken against the U.S. tax base.²¹⁷

In the subsidiary setting, the amount of a distribution for purposes of the dividend tax is reduced by the amount of any liability of the subsidiary that is assumed by the parent in connection with the distribution.²¹⁸ Thus, the dividend tax will not apply where a U.S. subsidiary transfers funds to its foreign parent and the parent assumes

²¹⁴ This assumes that the foreign corporation's effectively connected E&P for the year exceeds the increase in U.S. net equity, disregarding the reduction in U.S. liabilities.

²¹⁵ Treasury used a similar construct in analyzing the use of imputed liabilities to determine U.S. net equity. See Preamble to Temporary and Proposed Regulations under Section 884, *reprinted in Service Issues Branch Profits Tax Regulation*, TAX NOTES TODAY (Aug. 30, 1988) (LEXIS, FEDTAX lib., TNT file, elec. cit., 88 TNT 178-2) (treating an increase in the amount of liabilities imputed to the U.S. branch as analogous to a U.S. subsidiary's assumption of a portion of the liabilities of its foreign parent; apparently viewing a decrease in the branch's imputed liabilities as analogous to an assumption by a foreign parent of liabilities of its U.S. subsidiary).

²¹⁶ In the branch setting, this is a result of the assumed fact that effectively connected E&P exceeds the increase in U.S. net equity, disregarding the reduction in U.S. liabilities. See *supra* note 214.

²¹⁷ As discussed earlier, it is appropriate to consider the tax consequences of the reduction of liabilities in the branch and subsidiary settings despite the legal differences involved. See *supra* notes 189-90 and accompanying text. In this regard, it should be noted that the interest rate on U.S. booked liabilities that are treated as assumed in the branch setting may continue to affect the determination of the U.S. branch's interest deduction (if the foreign corporation uses the adjusted U.S. booked liabilities method, see *supra* notes 209-10 and accompanying text), while the interest rate on liabilities that are actually assumed in the subsidiary setting will no longer affect the determination of the U.S. subsidiary's interest deduction. However, this does not appear to be a significant enough difference to prevent the application of this construct.

²¹⁸ See I.R.C. § 301(b)(2). For this purpose, the liability must be assumed within the meaning of section 357(d), which generally requires that (i) in the case of recourse liabilities, the transferee has agreed to, and is expected to satisfy the liability, whether or not the transferor is relieved of the liability, and (ii) in the case of nonrecourse liabilities, the transferee acquires any asset subject to the liability. See Treas. Reg. § 1.301-1(g)(1) (2003); I.R.C. § 357(d)(1)(A).

an equal amount of liabilities of the subsidiary.²¹⁹ To promote the neutral tax treatment of U.S. branches and U.S. subsidiaries, a foreign corporation with a U.S. branch should have the same opportunity to shift funds outside of the United States without incurring a second-level tax, by reducing the amount of liabilities that are taken into account for U.S. tax purposes. Therefore, neutrality would be better achieved by permitting a foreign corporation for purposes of the branch profits tax (and interest deduction calculation) to reduce its U.S. liabilities below the amount of its U.S. booked liabilities.²²⁰

Upon the termination of the U.S. branch, there should be no recapture of earnings that are accumulated as a result of the enhanced election to reduce liabilities, for reasons similar to those expressed in the previous section.²²¹ Where a U.S. subsidiary transfers funds to its foreign parent in connection with the parent's assumption of

²¹⁹ Although it is unlikely that a shareholder would assume a corporate liability in connection with a cash distribution (as opposed to property distribution), the amount of the distribution would be reduced by the liability assumed. See BITTKER & EUSTICE, *supra* note 91, at 8-11. If the amount of earnings transferred by the U.S. subsidiary is equal to the amount of third party liabilities assumed by the foreign parent, the amount of the distribution would be zero, as the transferred earnings would be fully offset by the additional third party liabilities assumed by the parent. With a distribution of zero, there would be no dividend (and therefore no gross income) under section 301(c)(1). Consequently, there would be no FDAP income for purposes of section 881(a). See Treas. Reg. § 1.1441-2(b)(1) (2000) (FDAP income requires that there be gross income).

²²⁰ As noted above, an assumption of liabilities will be treated as occurring in the U.S. subsidiary setting only if the parties satisfy certain standards contained in section 357(d). See *supra* note 218. To bring about similar treatment in the U.S. branch setting, in connection with this proposal consideration should be given to limiting a reduction in U.S. liabilities in circumstances that are analogous to those where section 357(d) would not treat a transferred liability as being assumed. For example, a reduction below the amount of U.S. booked liabilities could be prevented where the foreign branches of a foreign corporation have minimal net equity (non-U.S. assets less non-U.S.-connected liabilities (non-U.S. assets multiplied by the foreign corporation's actual or fixed liability-to-asset ratio)) on the view that a similarly situated foreign parent would not be expected to satisfy a transferred recourse liability in this situation. In addition, a reduction below the amount of U.S. booked nonrecourse liabilities could be prevented to the extent that these liabilities encumber U.S. assets. Of course, these factors in the branch setting have no bearing on who is likely to bear the liability (unlike the subsidiary setting); nevertheless, it may be appropriate to take them into account in permitting a reduction below the amount of U.S. booked liabilities, in order to prevent a U.S. branch from having a greater ability to avoid a second-level tax as compared to a similarly situated U.S. subsidiary.

²²¹ See *supra* Part IV.B.

subsidiary liabilities, the foreign parent will not be taxable on the liquidation of the subsidiary to the extent of the prior transfer, regardless of whether there are subsequent infusions of assets into the subsidiary. Likewise, a foreign corporation with a U.S. branch should not be taxable in the analogous situation upon the termination of the branch.

While it may be contended that a more available election to reduce branch liabilities would result in the effective repeal of the branch profits tax, exposure to the tax may still exist. Once the foreign corporation reduces its U.S. liabilities to zero, the branch profits tax would apply to the extent that effectively connected E&P is not invested in additional U.S. assets.²²² More importantly in terms of neutrality, avoiding the branch profits tax through a more liberal election would produce an indirect tax cost due to the loss of interest deductions against effectively connected income. Again, this is similar to the treatment of a similarly situated U.S. subsidiary, and consistent with the approach generally allowing for the avoidance of second-level taxes at the cost of having the income generated by the invested earnings subject to net basis U.S. taxation, which is effectively the case with loss of interest deductions.²²³

2. Potential Policy Conflicts

Removing the U.S. booked liability limitation, in conjunction with eliminating the recapture rule, should not raise any additional policy conflicts, but would exacerbate the potential conflict examined above. That is, without this limitation, a foreign corporation would be able to make further reductions in the liability-to-asset ratio of its U.S. branch, thus arguably offending fungibility to a greater degree. However, because liability reductions do not violate the thin capitalization concerns underlying fungibility,²²⁴ an enhanced ability to reduce branch liabilities should not run counter to this policy.

²²² Because banks are so highly leveraged, it appears very unlikely that a U.S. banking branch would exhaust its ability to use the liability reduction election with the removal of U.S. booked liability limitation, although there still may be some limits on reducing U.S. liabilities as discussed at *supra* note 220. Consequently, the removal of this limitation may indeed eliminate exposure under the branch profits tax for foreign banks.

²²³ See *supra* note 194.

²²⁴ See *supra* Part IV.B.2.

D. Providing an Election to Treat Assets as Effectively Connected

1. Promoting Neutrality

Even with the suggested changes to the liability reduction election, differences would still remain in the application of the branch profits and dividend taxes. Specifically, aside from reducing its U.S. liabilities, a foreign corporation could only avoid a branch profits tax on its U.S. branch earnings to the extent that it invested the earnings in U.S. assets, that is, assets that generally produce effectively connected income.²²⁵ This generally means that the assets must bear some connection to the business conducted by the U.S. branch.²²⁶ In contrast, a similarly situated U.S. subsidiary would avoid a dividend tax on any earnings that it retains. Moreover, there appears to be little possibility that the accumulated earnings tax would apply on the retained earnings of the U.S. subsidiary as a surrogate for a second-level tax, and the personal holding company tax, even if potentially applicable, typically should allow for generous accumulations without the risk of penalty.²²⁷ Accordingly, a U.S. subsidiary would likely not be subject to a second-level tax on earnings invested by the subsidiary in assets that are unrelated to the conduct of its U.S. business, whereas a similarly situated U.S. branch may well face a branch profits tax liability in these circumstances.²²⁸

²²⁵ See *supra* note 101 and accompanying text. As noted earlier, it appears very unlikely that a foreign corporation conducting a U.S. banking business would exhaust its ability to use the liability reduction election as modified in this article. See *supra* note 222. On the other hand, foreign corporations conducting nonbanking activities in the United States may well be limited in their ability to accumulate earnings effectively pursuant to the expanded liability reduction election, given their lower liability-to-asset ratios. Cf. Lederman & Hirsh, *supra* note 73, at 113 (pointing out that foreign corporations financed primarily by equity can benefit little from the current liability reduction election).

²²⁶ See *supra* notes 102–38 and accompanying text.

²²⁷ See *supra* notes 83–98 and accompanying text.

²²⁸ See *supra* notes 121–38 and accompanying text; Blessing, *supra* note 46, at 638 (referring to the fact that a U.S. subsidiary can invest earnings in nonbusiness assets or outside the United States without incurring a second-level tax, and characterizing this as a potentially significant timing advantage versus operations using a U.S. branch). An exception would be where a foreign corporation invested its earnings in U.S. real estate held for investment and elected under section 882(d) to treat the income with respect to the property as effectively connected. See *supra* note 106 and accompanying text.

This assumes that the foreign corporation exhausted its ability to use the liability reduction election, as modified in this article, to accumulate earnings effectively. As

Furthermore, unlike a U.S. subsidiary, a U.S. branch would lack the certainty that the earnings will be treated as retained.²²⁹ Consequently, absent other changes, a U.S. subsidiary would continue to have greater flexibility and certainty in avoiding a second-level tax on its earnings as compared to a U.S. branch.

It may be contended that for purposes of a neutrality analysis the hypothetical U.S. subsidiary construct for a U.S. branch should be confined to items that bear some factual connection to the foreign corporation's U.S. business. Accordingly, under this view, U.S. branch earnings that are invested in assets unrelated to the foreign corporation's U.S. business should be treated as if they had been distributed by a hypothetical U.S. subsidiary, thus justifying the current rules for determining U.S. assets under the branch profits tax. However, the Congressional reports accompanying the branch profits tax do not mandate such a construct, and instead appear to espouse a "tax" approach, as opposed to "factual connection" approach, for conceptualizing a U.S. branch. According to the legislative history, U.S. net equity should take into account assets and liabilities that are *treated* as connected with the business of the U.S. branch.²³⁰ These are assets and liabilities that generate income that is taxable by the United States on a net basis.²³¹ Further indication of a tax approach is Congress's intention to apply the branch profits tax to investment

noted earlier, it appears very unlikely for this to occur with respect to a foreign corporation conducting a U.S. banking business. *See supra* note 222.

²²⁹ *See supra* notes 139–44 and accompanying text.

²³⁰ *See* 1986 Bluebook, *supra* note 9, at 1040; S. REP. NO. 99-313, *supra* note 12, at 404; H.R. REP. NO. 99-426, *supra* note 12, at 434. As noted earlier, the regulations implement this approach with respect to liabilities by eschewing a factual relationship approach and instead using liabilities that are imputed for purposes of computing the U.S. branch's interest expense deduction. *See supra* note 43 and accompanying text. It should be noted, however, that the Senate report may call for a factual connection approach for conceptualizing a U.S. branch, in that the report states that U.S. assets should include cash needed to meet daily operating expenses, inventory, equipment, and other assets necessary to operate the business. *See* S. REP. NO. 99-313, *supra* note 12, at 404. Nevertheless, the report also lists investments generating effectively connected income as an example of items that should qualify as U.S. assets. *See id.* This report goes on to state that U.S. liabilities are liabilities directly related to the income of the U.S. branch and include payables, short-term obligations, and other liabilities necessary to meet obligations of the foreign corporation's U.S. business. *See id.* Thus, the statements in the Senate report are called into question, as they appear to endorse a factual relationship approach for determining U.S. liabilities, which is inconsistent with the explanation provided in the Bluebook, and has been flatly rejected by Treasury.

²³¹ *See* 1986 Bluebook, *supra* note 9, at 1040.

income from U.S. real property where a foreign corporation has elected to treat such income as effectively connected pursuant to section 882(d).²³² Thus, expanding the definition of U.S. assets to include assets unrelated to the foreign corporation's U.S. business appears to be consistent with the legislative history of the branch profits tax, provided that the assets are also treated as generating income subject to net basis U.S. taxation.²³³ And using a factual connection approach to determine the contours of a U.S. branch as a hypothetical subsidiary ignores the fact that a U.S. subsidiary can retain its earnings in nonbusiness assets. Thus, a factual connection approach for conceptualizing a U.S. branch disregards what an actual subsidiary could do to avoid a dividend tax, an essential factor to consider in achieving branch/subsidiary neutrality in the imposition of second-level taxes.

Providing foreign corporations with an election to treat assets as effectively connected, and thus as U.S. assets, would remove this disparity in the application of the branch profits and dividend taxes. Specifically, Congress (or possibly Treasury) should expand the definition of effectively connected assets to include, upon election by a foreign corporation, investment assets giving rise to U.S. source income.²³⁴ As a result, a foreign corporation could avoid the branch

²³² See *id.* In this regard, the regulations provide that for purposes of determining effectively connected E&P and U.S. assets, effectively connected income includes income that is treated as effectively connected under any provision of the Code. See Treas. Reg. § 1.884-1(f)(1), (d)(1)(iii) (1996); *cf.* Treas. Reg. § 1.884-1(d)(2)(xi) (1996) (holding that U.S. real estate held for investment is not a U.S. asset where the foreign corporation did not make an election under section 882(d)).

²³³ Indeed, Treasury apparently came to this conclusion in providing for the limited expansion capital election in the proposed and temporary branch profits tax regulations. See *infra* note 240.

²³⁴ This proposal assumes no changes in the law with regard to the application of the accumulated earnings tax to a wholly owned U.S. subsidiary of a foreign corporation. If, however, a change is made to the accumulated earnings tax, so that it can potentially apply in all cases in the U.S. subsidiary setting, this article would continue to recommend that foreign corporations be permitted an election to treat U.S. source investment assets as effectively connected, but only if the assets are held to meet the reasonable needs of the foreign corporation's U.S. business. This alternative is discussed in Part IV.E.

Under the proposal suggested here, only assets generating U.S. source income would be eligible for effectively connected treatment pursuant to an election. Because a U.S. subsidiary can accumulate earnings in foreign assets as well as domestic assets, neutrality suggests that U.S. branches also should be permitted to elect effectively connected treatment for assets generating foreign source income. While this may deserve some consideration, U.S. branches should have sufficient

profits tax by investing its U.S. branch earnings in debt instruments, stock, or other investment assets generating U.S. source income,²³⁵ provided the assets are elected to be treated as effectively connected.²³⁶ As discussed below, a foreign corporation should not be permitted to elect effectively connected treatment for a greater amount of assets than is necessary to reduce its dividend equivalent amount to zero for a particular year.²³⁷ Of course, this change would (and should) also result in the income from such assets being subject to net basis taxation under the effectively connected income tax regime, as opposed to gross basis taxation under the U.S. source/FDAP income regime.²³⁸ This would include current income on elected assets as well as any gain (or loss) from the disposition of such assets.²³⁹ By so expanding the definition of effectively connected

flexibility in retaining earnings without extending the election to foreign assets. Moreover, with the election applying to foreign assets, a foreign corporation may be entitled to a foreign tax credit (pursuant to section 906) that could deprive the United States of the ability to tax the income generated by the assets. *See* I.R.C. § 906. In this regard, a secondary purpose of the branch profits tax may be to generate revenue gains by encouraging the reinvestment of U.S. earnings. *See* Blessing, *supra* note 46, at 589 n.18.

Some consideration should be given to excluding foreign banks from having the election to effectively connect investment assets. As noted earlier, it appears very unlikely that a foreign corporation conducting a U.S. banking business would exhaust its ability to use the liability reduction election as modified in this article. *See supra* note 222. Consequently, a foreign bank may well avoid any exposure under the branch profits tax by reducing its U.S. liabilities, and thus may not need an election to effectively connect assets in order to avoid the tax. On the other hand, a U.S. banking branch could still benefit from the certainty in retaining earnings that would be provided by the effectively connected election. *See supra* note 141; *cf. infra* note 242. Moreover, a similarly situated U.S. subsidiary would have the ability to avoid a dividend tax either by retaining earnings or using earnings to pay down its liabilities.

²³⁵ As an alternative, an elective, expanded rule for effectively connected assets could exclude stock. This alternative is addressed in the next section. *See infra* notes 274–78 and accompanying text.

²³⁶ A foreign corporation would be able to couple an election to treat assets as effectively connected with an election to reduce liabilities, which would allow for an increase in U.S. net equity equal to the full amount invested in elected assets.

²³⁷ *See infra* notes 285–89 and accompanying text.

²³⁸ As examined in the next section, this aspect may conflict with policies underlying the effectively connected income rules. *See infra* Part IV.D.2.a.

²³⁹ Most income tax treaties reduce the rate of tax that the source country can impose on interest and dividends, as well as generally prevent the source country from taxing gain from the disposition of property, unless the interest, dividends or gains are attributable to a permanent establishment or fixed base that a foreign person has in the source country. *See, e.g.,* MODEL CONVENTION, *supra* note 26, at

assets, both U.S. branches and U.S. subsidiaries could invest in expansion capital and nonbusiness assets without generally incurring a second-level tax on the invested earnings, with the income on these investments subject to net basis taxation.²⁴⁰ Like a U.S. subsidiary, a

art. 10 (dividends), art. 11 (interest), art. 13 (gains). For income to be attributable to a permanent establishment, the income generally needs to be derived from the assets or activities of the permanent establishment. *See, e.g.*, MODEL CONVENTION, *supra* note 26, at art. 7, para. 2. Because assets that are elected as effectively connected may bear no relationship to a foreign corporation's U.S. permanent establishment, the income and gain on these assets be subject to treaty provisions that limit the United States' ability to tax these items. Accordingly, to allow the United States to subject the income and gain from elected assets to full net basis taxation, an election to treat assets as effectively connected should be coupled with a waiver of any available treaty benefits. *Cf.* Temp. Treas. Reg. § 1.897-6T(b)(2)(ii) (2003) (conditioning the availability of nonrecognition treatment for certain foreign to foreign exchanges of U.S. real property interests under FIRPTA on the waiver of certain treaty benefits).

²⁴⁰ The proposed and temporary regulations under section 884 contained a limited version of this approach, allowing a foreign corporation to include as U.S. assets certain investment assets that otherwise did not give rise to effectively connected income. *See* former Temp. Treas. Reg. § 1.884-1T(d)(11) (1988). Under this provision, a foreign corporation could make an annual election to treat marketable securities as U.S. assets in amount not greater than twenty-five percent of the effectively connected E&P for the current and prior two years. The elected securities were treated as U.S. assets only for the year of the election, with the income from the securities being treated as effectively connected for the year following the year of the election. The final branch profits tax did not include this expansion capital election, instead substituting the liability reduction election as a means of providing some relief from the automatic nature of the branch profits tax. *See* T.D. 8432, 1992-2 C.B. 157. Treasury abandoned the expansion capital election in the final regulations because it proved to be ineffective in allowing foreign corporations to retain earnings for expansion without the imposition of a current branch profits tax, given that additional U.S. liabilities would be imputed on the invested earnings. *See id.* With the liability reduction election (as modified by the proposals contained in this article), the same problems would not exist under the proposal to expand the definition of effectively connected assets, because a foreign corporation would be able to couple an election to treat assets as effectively connected with an election to reduce liabilities, and thereby generate a sufficient increase in U.S. net equity to avoid a current branch profits tax liability.

The former expansion capital election and my proposal do differ in a major respect. I am recommending that foreign corporations be permitted to treat investment assets as effectively connected, limited by the amount necessary to reduce the dividend equivalent amount to zero, in order to achieve parity with U.S. subsidiary operations in the application of second-level taxes. In contrast, the proposed and temporary regulations allowed a limited amount of marketable securities to be treated temporarily as U.S. assets, as a way of permitting a temporary investment of U.S. branch earnings in non-U.S. business assets. Other commentators have similarly proposed expanding the definition of effectively connected assets to

U.S. branch would then have a choice, and with nearly certain results,²⁴¹ of whether to incur a second-level tax or instead have the income generated by invested earnings taxed by the United States on a net basis.²⁴²

Along with this election to effectively connect assets, the Service should have some ability to treat elected assets as non-U.S. assets in order to approximate the application of the penalty taxes on undistributed earnings in the U.S. subsidiary setting. In the atypical circumstance where a privately-held foreign parent of a U.S. subsidiary has one or more U.S. individual shareholders, the accumulated earnings tax would be potentially applicable to the U.S. subsidiary.²⁴³ Accordingly, for the analogous situation of a U.S. branch of a privately-held foreign corporation having U.S. individual shareholders, the Service should be able to treat elected assets as non-U.S. assets to the extent that the amount of elected assets is beyond what is reasonably necessary for the foreign corporation's U.S.

include, upon election, investment assets in order to create parity between a U.S. subsidiary and a U.S. branch. See, e.g., *Peat Marwick Comments*, *supra* note 16 (commenting on the proposed and temporary branch profits tax regulations and pointing out that a U.S. subsidiary can dispose of part of its business and temporarily invest the proceeds in marketable securities instead of distributing the funds to its foreign parent).

²⁴¹ See *infra* notes 243–52 and accompanying text.

²⁴² As discussed earlier, it is possible that the presumption rule contained in the asset-use test provides nonbanking branches with an ability to retain earnings similar to that of U.S. subsidiaries. See *supra* notes 128–33 and accompanying text. Consequently, it may be argued the proposed changes are not necessary to achieve neutrality in this regard. However, even if the presumption rule allows for effectively connected treatment of assets that are unrelated to meeting the present needs of the U.S. business, foreign corporations should still be provided with the election to treat investment assets generating U.S. source income as U.S. assets. The presumption rule, with its fact-specific standards, does not provide the certainty of treatment that a U.S. subsidiary typically has in retaining earnings. In this regard, branch profits tax liability can arise unexpectedly where a foreign corporation unwittingly acquires non-U.S. assets, and the problem may become known only when the foreign corporation's tax return is prepared. See *Genz*, *supra* note 61, at 135. Allowing U.S. branches to elect U.S. asset treatment prior to the return due date would provide them with the certainty of earnings retention that exists in the subsidiary setting. In addition, providing foreign corporations with a straightforward election to retain earnings would have simplification benefits for the government as well as taxpayers. Similar considerations apply with regard to the contention that U.S. banking branches do not need an election to effectively connect assets, because they currently have sufficient flexibility in retaining earnings. See *supra* notes 135–38 and accompanying text.

²⁴³ See *supra* notes 83–89 and accompanying text.

business.²⁴⁴ Consideration should be given to applying this treatment to U.S. branches of publicly-held foreign corporations as well.²⁴⁵ Such reclassification by the Service would likely lead to a larger dividend equivalent amount for the particular year, thus approximating the second-level tax that would be imposed on a similarly situated U.S. subsidiary under the accumulated earnings tax.²⁴⁶ Alternatively, in these situations, the Service could curb excessive accumulations in elected assets by applying the accumulated earnings tax itself to the foreign corporation. Because the situations involve foreign corporations with one or more U.S. individual shareholders, the accumulated earnings tax generally should apply²⁴⁷ if the foreign corporation accumulates earnings to avoid the individual income tax on its shareholders.²⁴⁸

²⁴⁴ For this purpose, the standard should be the same as under the accumulated earnings tax. See *infra* note 311. In rare situations, the accumulated earnings tax also would be potentially applicable to a U.S. subsidiary of a foreign parent with only foreign shareholders. See *supra* notes 85–87 and accompanying text. Consequently, consideration should be given to allowing potential reclassification of elected assets for analogous situations involving U.S. branches of foreign corporations with only foreign shareholders. See *supra* note 87 for such analogous situations.

²⁴⁵ Where a widely-held foreign parent has some U.S. shareholders, it appears to be very unlikely that a U.S. subsidiary of the foreign parent would be found to accumulate earnings in order to avoid the individual tax on the foreign parent's U.S. shareholders. See *supra* notes 90–93 and accompanying text. Consequently, while consideration should be given to applying the accumulated earnings tax analogue to U.S. branches of widely-held foreign corporations, this may not be appropriate given the treatment of similarly situated U.S. subsidiaries. Perhaps the analogue should only apply where there is evidence that an unreasonable accumulation occurred in order to benefit directly the U.S. shareholders of the widely-held foreign corporation.

²⁴⁶ This raises issues as to whether reclassified assets should nevertheless be treated as effectively connected for regular tax purposes, as well as whether modifications to the branch profits tax may be appropriate given that the accumulated earnings tax can function as a third level of taxation. These issues are examined at *infra* note 311.

²⁴⁷ See Treas. Reg. § 1.532-1(c) (1959) (stating that, among other circumstances, the accumulated earnings tax is applicable to a foreign corporation if any of its shareholders are U.S. citizens or residents); I.R.C. § 532(b) (noting that passive foreign investment companies are excluded from the application of the accumulated earnings tax).

²⁴⁸ However, the application of the accumulated earnings tax to a foreign corporation may differ from the application of the tax to a U.S. subsidiary conducting a U.S. business, the construct for a U.S. branch. This is because the former would take into account the needs of any U.S. or foreign businesses of the foreign corporation, whereas the latter may be limited to taking into account only the U.S. business needs of the U.S. subsidiary. Cf. Treas. Reg. § 1.537-3(b) (1959) (providing that under certain circumstances the business of a subsidiary may be considered the

Similarly, the Service should be able to treat elected assets as non-U.S. assets in circumstances analogous to those where a similarly situated U.S. subsidiary would be subject to the personal holding company tax.²⁴⁹ Specifically, reclassification could occur for a taxable year (“the current year”) in situations where the gross income from all elected assets (whether elected in the current year or any other year) equals or exceeds sixty percent of the foreign corporation’s effectively connected gross income for the current year, provided more than fifty percent of the foreign corporation’s stock is owned (directly or indirectly) by five or fewer individuals at any time during the last half of the current year.²⁵⁰ In this case, assets elected in the current year would be reclassified as non-U.S. assets. As with the analogue to the accumulated earnings tax, reclassification would likely increase the dividend equivalent amount for the year,²⁵¹ resulting in a second-level

business of the parent for purposes of applying the reasonable needs of the business standard to the parent). *But see* *Inland Terminals, Inc. v. U.S.*, 477 F.2d 836 (4th Cir. 1973) (holding that the reasonable business needs of a wholly-owned subsidiary include the reasonable business needs of its parent). Thus, given the U.S. subsidiary construct for a U.S. branch, it may be more appropriate to consider only the needs of the U.S. business in curbing excess accumulations, which is what the accumulated earnings tax analogue does. Of course, it would also be possible to modify the application of the accumulated earnings tax to foreign corporations so as only to take into account the needs of a foreign corporation’s U.S. business.

²⁴⁹ As a result of a 2004 amendment, the personal holding company tax no longer applies to foreign corporations. *See* I.R.C. § 542(c)(5). Even before the 2004 change, the personal holding company tax did not apply to a foreign corporation owned entirely by nonresident aliens, either directly or indirectly through foreign entities. *See* former I.R.C. § 542(c)(7). Consequently, an analogue to the personal holding tax is needed in order to treat U.S. branches and U.S. subsidiaries similarly with regard to excessive accumulations. Excluded from the application of the personal holding company tax are several types of corporations, including banks, life insurance companies, and lending or finance companies. *See* I.R.C. § 542(c). To promote neutrality, there should be similar exclusions in applying the personal holding company analogue to U.S. branches.

²⁵⁰ *Cf. supra* notes 94–98 and accompanying text.

²⁵¹ As with the analogue to the accumulated earnings tax, this raises issues as to whether reclassified assets should nevertheless be treated as effectively connected for regular tax purposes, as well as whether modifications to the branch profits tax may be appropriate given that the personal holding company tax can function as a third level of taxation. These issues are examined at *infra* note 311, in the context of an analogue to the accumulated earnings tax that is contained in an alternative proposal providing an effectively connected election. In this connection, a third level of tax is less likely with the application of the personal holding tax as compared to the accumulated earnings tax, because of the deficiency dividend procedure contained in section 547; thus, there is less justification for modifying the branch profits tax for

tax similar to imposing the personal holding company tax in the subsidiary setting.²⁵²

It may be contended that the election to treat assets as effectively connected would result in the effective repeal of the branch profits tax. With this feature, foreign corporations would often have the ability to eliminate their liability under the branch profits tax by electing to treat a sufficient amount of assets as being effectively connected (possibly coupled with an election to reduce U.S. liabilities). Nevertheless, the election would likely also produce a cost, in that the income generated by the affected assets would be subject to U.S. net basis taxation. While dividend-paying stock would probably fare better under net basis taxation as compared to gross basis taxation because of the dividends-received deduction,²⁵³ debt instruments and growth stock would likely do worse tax-wise given the general exemptions for interest²⁵⁴ and asset gains²⁵⁵ under the withholding tax. If, as alternatively suggested below, stock were ineligible for effectively connected treatment,²⁵⁶ the election would likely result in greater U.S. tax on the income produced by the affected assets.²⁵⁷ Consequently, the branch profits tax would continue to affect, albeit indirectly, the U.S. tax liability of foreign

purposes of implementing an analogue to the personal holding companying tax.

²⁵² As an alternative to this rough analogue to the personal holding company tax, consideration should be given towards developing a more precise analogue that applies the details of the personal holding company tax to a U.S. branch. *Cf. supra* notes 94–98 and accompanying text. Such an approach could apply the specific rules of the personal holding company tax, but only taking into account a foreign corporation's effectively connected income. This could include the imposition of a separate penalty tax on a foreign corporation's "undistributed effectively connected personal holding company income," if the personal holding company ownership and income tests are met. This more precise analogue could apply regardless of whether a foreign corporation elects to treat assets as effectively connected.

²⁵³ See I.R.C. § 243.

²⁵⁴ See I.R.C. §§ 881(c), (d).

²⁵⁵ See I.R.C. § 881; Treas. Reg. § 1.1441-2(b) (2000).

²⁵⁶ See *infra* notes 274–78 and accompanying text.

²⁵⁷ If, however, the additional U.S. assets resulted in additional U.S.-connected liabilities and therefore deductible interest, this would reduce the taxable income generated by the additional assets. However, the foreign corporation may want to reduce the amount of U.S.-connected liabilities (and U.S. liabilities) that would be imputed to the additional U.S. assets in order to reduce its branch profits tax exposure (by increasing its U.S. net equity). Moreover, there would be limits on a foreign corporation's ability to use the effectively connected election to increase its deductible interest. See *infra* notes 285–89 and accompanying text.

corporations' U.S. branch operations,²⁵⁸ and in a manner that is similar to the way in which the dividend tax affects similarly situated U.S. subsidiaries. Thus, similar to a U.S. subsidiary, a U.S. branch generally would have a choice of whether to incur a branch profits tax or instead have the income on the invested earnings subject to net basis U.S. taxation.²⁵⁹

2. Potential Policy Conflicts

a. Policies Underlying the Effectively Connected Income Rules

At first blush, it would appear that permitting foreign corporations to elect effectively connected treatment of investment assets that are unrelated to the conduct of the foreign corporation's U.S. business would violate the policies underlying the effectively connected income rules. After all, such a change arguably runs counter to section 864(c)(2), which, as explicated by its legislative history, appears to require a factual connection between the income (or underlying asset) and the activities of the foreign corporation's U.S. trade or business in order for U.S. source capital gain or FDAP income to be effectively connected.²⁶⁰ Indeed, a statutory amendment to this section may well be required to effectuate this change.²⁶¹ However, a closer examination suggests that such an expansion of effectively connected assets does not appear to implicate the concerns that led to the adoption of a factual connection standard for subjecting income on investment assets to net basis taxation.

²⁵⁸ In this regard, another reason for the branch profits may have been to generate revenue gains by encouraging the reinvestment of U.S. branch earnings. See Blessing, *supra* note 46, at 589.

²⁵⁹ See *supra* text accompanying notes 155–60.

²⁶⁰ See S. REP. NO. 1707, 89TH CONG., 2D SESS. (1966), *reprinted in* 1966-2 C.B. 1055; H.R. REP. NO. 1450, *supra* note 133.

²⁶¹ That is, Treasury may lack the power to effectuate the change by amending the regulations under section 864(c). In this regard, the House and Senate reports in explaining the application of section 864(c)(2) state “[t]hus, for example, are the assets held for future, or remittent, use in the business?” See S. REP. NO. 1707, *supra* note 260, at 1072; H.R. REP. NO. 1450, *supra* note 130, at 977. This would appear to exclude investment assets that have no connection to the foreign corporation's U.S. business. On the other hand, Treasury felt that it had the power to promulgate the former expansion capital election (contained in the former temporary branch tax regulations), which likewise did not require a relationship between the holding of the elected assets and the conduct of the U.S. business. See *supra* note 240.

Prior to the enactment of section 864(c)(2), a foreign person with a U.S. business was subject to net basis taxation on all of its U.S. source income, under the so-called "force of attraction" rule.²⁶² Several concerns led Congress to adopt the factual connection standard contained in section 864(c)(2) in place of the force of attraction rule for U.S. source investment income. First, Congress was concerned that the force of attraction rule distorted a foreign corporation's decision of whether to engage in business or invest in the United States.²⁶³ This rule may have deterred foreign corporations with U.S. source investment income from engaging in a U.S. business because doing so would subject the investment income to net basis taxation without any applicable treaty reductions in the tax rate.²⁶⁴ Similarly, the force of attraction rule may also have deterred a foreign corporation with a U.S. business from investing in the United States.²⁶⁵ Congress also believed that the substantial difference in the tax treatment of U.S. investment income, depending on the existence (or not) of an unrelated U.S. business, was both inequitable and illogical.²⁶⁶

In addition, Congress wanted to ensure that U.S. source dividends generally are fully subject to U.S. tax.²⁶⁷ Net basis taxation of dividends provides a foreign corporation with a dividends-received deduction, which removes at least seventy percent of the dividend from the taxable base.²⁶⁸ Also, prior to the enactment of the branch profits tax,²⁶⁹ there rarely was a second-level U.S. tax on the dividends when these amounts were ultimately distributed to the shareholders of

²⁶² See H.R. REP. NO. 1450, *supra* note 133, 1966-2 C.B. at 972; Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 690 (1987).

²⁶³ See H.R. REP. NO. 1450, *supra* note 133, 1966-2 C.B. at 976.

²⁶⁴ See *id.*

²⁶⁵ See *id.*

²⁶⁶ See *id.*

²⁶⁷ See I.R.S. Tech. Adv. Mem. 89-40-005 (May 15, 1989) (referring to a May 13, 1966 statement by Stanley Surrey, Assistant Secretary of Treasury, before the Senate Foreign Relations Subcommittee on Tax Conventions, for proposition that Congress intentionally drew the effectively connected test narrowly because of concern over the ability of foreign corporations to effectively connect dividends and thereby take advantage of the dividends-received deduction to virtually eliminate U.S. tax on the dividends).

²⁶⁸ See I.R.C. § 243(a). At the time that section 864(c)(2) was enacted, section 243 generally provided for an eighty-five percent dividends-received deduction. See former I.R.C. § 243(a) (1964).

²⁶⁹ This was the case when Congress adopted section 864(c)(2).

the foreign corporation.²⁷⁰ Consequently, the factual connection standard contained in section 864(c)(2) was aimed in part at channeling most U.S. source dividends to gross basis taxation under the U.S. source/FDAP regime,²⁷¹ so as to include the full amount of the dividend in the taxable base.

Providing an election to treat assets as effectively connected does not appear to implicate the concerns that led to the adoption of the factual connection standard contained in section 864(c)(2). First, foreign corporations should not be deterred from engaging in business or investing in the United States because they always can refrain from electing effectively connected status for the investments. This nonelection would subject the investment income to the tax under section 881(a) (including any exemptions or exceptions) along with any applicable treaty reductions.²⁷² Also, allowing a foreign corporation to elect net basis taxation for investment income does not appear to be inequitable or illogical, given that a foreign corporation with a U.S. subsidiary can effectively do the same by having the U.S. subsidiary hold the investments.²⁷³

Finally, it would appear that elective net basis taxation of U.S. dividends (with a corresponding dividends-received deduction) is not inconsistent with Congress's desire to have U.S. source dividends fully taxed in most cases. Unlike the ineffective second-level U.S. tax that existed upon the enactment of section 864(c)(2), the dividends generally will be fully subject to a second-level U.S. tax under the branch profits tax when treated as remitted outside of the United States.²⁷⁴ Although prior dividends may escape a second-level tax upon a tax-free termination of the U.S. branch,²⁷⁵ this is no different than the tax treatment of dividends received by a U.S. subsidiary where the subsidiary liquidates into its foreign parent before making nonliquidating distributions of the earnings generated by the prior

²⁷⁰ See *supra* note 28 and accompanying text.

²⁷¹ To the extent not effectively connected, U.S. source dividends are generally taxable under section 881(a).

²⁷² This assumes that the income is not otherwise effectively connected.

²⁷³ As mentioned earlier, however, the legislative history to section 864(c)(2) indicates that Congress was concerned with subjecting investment income to net basis taxation based on the existence of an unrelated U.S. business conducted by the taxpayer. See *supra* note 266 and accompanying text.

²⁷⁴ While not indicated in the legislative history, the lack of an effective second-level U.S. tax under prior law may have been an important factor in Congress's decision to limit the ability to have U.S. source dividends subject to net basis taxation.

²⁷⁵ See *supra* notes 148–49 and accompanying text.

dividends.²⁷⁶ Nevertheless, if one desires greater assurance of fully taxing U.S. source dividends, an alternative would be to exclude stock investments from the election to effectively connect assets. Possibly for this reason,²⁷⁷ Treas. Reg. § 1.864-4(c)(2) generally excludes stock as an asset that is eligible for effectively connected treatment under the asset use test.²⁷⁸

b. Other Policies

The proposal to provide foreign corporations with an election to effectively connect assets may also raise concerns of administrability. As discussed above, along with the election to treat investment assets as effectively connected, the Service should have some ability to treat elected assets as being noneffectively connected,²⁷⁹ which may further complicate the application of the branch profits tax. In particular, reclassification pursuant to the analogue to the accumulated earnings tax would require a determination of whether the investment is held to meet the reasonable needs of the foreign corporation's U.S. business,²⁸⁰ which would entail the somewhat nebulous standards and potential enforceability difficulties that arguably plague the accumulated earnings tax.²⁸¹ Nevertheless, the administrative burdens should be minimal in light of the limited situations where this type of reclassification may apply.²⁸² Moreover, the ability to elect effectively connected status for investment assets should reduce the number of situations where it is necessary to apply the asset-use test and its "held for the present needs" standard, along with its presumption rule.²⁸³

²⁷⁶ See *supra* note 146 and accompanying text.

²⁷⁷ Another, and probably more important, reason for excluding stock as an effectively connected asset under the asset-use test may be to prevent foreign corporations from effectively imputing interest deductions to assets that may not be producing current income. See *infra* notes 285–89 and accompanying text for a discussion of possible taxpayer manipulation of the interest deduction under Treas. Reg. § 1.882-5 with an elective effectively connected rule for investment assets.

²⁷⁸ See Treas. Reg. § 1.864-4(c)(2)(iii)(a) (2005). A recent amendment to the asset-use test removes the exclusion with respect to certain stock held by foreign insurance companies. See Treas. Reg. § 1.864-4(c)(2)(iii)(b) (2005); *supra* note 116.

²⁷⁹ See *supra* notes 243–52 and accompanying text.

²⁸⁰ See *supra* note 244 and accompanying text.

²⁸¹ See *infra* note 323.

²⁸² See *supra* notes 243–45 and accompanying text.

²⁸³ This is true because taxpayers desiring effectively connected treatment for investment assets would presumably be electing such treatment, rather than having the determination made under the asset-use test.

These tests can be uncertain in their application, and therefore avoiding them should make administration easier.²⁸⁴ Consequently, the suggested expansion of effectively connected assets should not result in significant administrative burdens, and may indeed serve to simplify the administration of the tax rules applying to U.S. branches.

Potential taxpayer manipulation may be another concern with a rule allowing for effectively connected treatment for investment assets upon a taxpayer's election. Specifically, foreign corporations may strategically elect effectively connected status for investment assets in order to increase their interest expense deduction under Treas. Reg. § 1.882-5. By increasing the amount of U.S. assets via the election, more interest expense would be imputed to a foreign corporation's U.S. branch;²⁸⁵ yet, because the additional U.S. assets may yield little or no current taxable income, the election could result in lower amounts of effectively connected taxable income.²⁸⁶ If stock were excluded as an asset eligible for elective effectively connected treatment, an alternative suggested above,²⁸⁷ the potential for such manipulation would be reduced. A straightforward way of eliminating any possibility for manipulation would be to decline to impute liabilities on assets elected for effectively connected treatment.²⁸⁸ Regardless, a foreign corporation should not be permitted to elect effectively connected treatment for a greater amount of assets than is necessary to reduce its dividend equivalent amount to zero for a particular year; neutrality in the application of second-level taxes requires no more than this. Moreover, the earnings stripping rule may apply to cap the amount of currently deductible interest.²⁸⁹

²⁸⁴ See *supra* notes 111–16, 125–33 and accompanying text; see, e.g., I.R.S. Tech. Adv. Mem. 89-40-005 (May 15, 1989), I.R.S. Tech. Adv. Mem. 77-29-027 (Mar. 29, 1977).

²⁸⁵ See *supra* note 43 for a discussion of Treas. Reg. § 1.882-5.

²⁸⁶ This appears to be Treasury's concern in taking the position in the regulations that stock generally cannot be effectively connected under the asset-use test. See Katz & Plambeck, *supra* note 213, at A-47.

²⁸⁷ See *supra* notes 274–78 and accompanying text.

²⁸⁸ Indeed, in many cases foreign corporations may desire this result in order to increase their U.S. net equity and thereby lower their dividend equivalent amount. Thus, in the absence of a rule that does not impute U.S. liabilities on elected assets, foreign corporations may want to achieve the same result by coupling an effectively connected election with an election to reduce U.S. liabilities.

²⁸⁹ See I.R.C. § 163(j); Prop. Treas. Reg. § 1.163(j)-8, 52 FR 24,996, 24,999 (July 2, 1987).

E. Election to Treat Assets as Effectively Connected with Changes to the Accumulated Earnings Tax

As noted above, the proposal to provide foreign corporations with an election to treat investment assets generating U.S. source income as effectively connected assets assumes that there are no changes with regard to the application of the accumulated earnings tax.²⁹⁰ Under current law, the accumulated earnings tax apparently would rarely even apply potentially to a U.S. subsidiary of a foreign corporation. If a change does occur, such that the accumulated earnings tax would be potentially applicable in all cases in the U.S. subsidiary setting, this section recommends that foreign corporations be permitted an election to treat U.S. source investment assets as effectively connected, provided the assets are held to meet the reasonable needs of the foreign corporation's U.S. business.

1. Possible Change in the Application of the Accumulated Earnings Tax to U.S. Subsidiaries

As previously discussed, in the typical situation involving a U.S. subsidiary of a foreign corporation, the accumulated earnings tax apparently would not even potentially apply, regardless of whether earnings are accumulated beyond the reasonable needs of the subsidiary's business. The regulations under this tax require a purpose to avoid the imposition of the individual income tax on the subsidiary's shareholders (either direct or indirect), and this purpose is very likely not to exist with respect to a wholly owned U.S. subsidiary of a privately-held foreign corporation with no individual U.S. shareholders (which should be the norm). Moreover, even though a widely-held foreign corporation may well have some U.S. shareholders, it appears very unlikely that its U.S. subsidiary would be found to accumulate earnings for the purpose of avoiding the individual tax on the foreign parent's U.S. shareholders. Thus, most U.S. subsidiaries of foreign corporations would appear to be able to retain earnings without the limitations imposed pursuant to the accumulated earnings tax.²⁹¹

Effectively exempting most U.S. subsidiaries of foreign corporations from the accumulated earnings tax is a questionable

²⁹⁰ See *supra* note 234.

²⁹¹ For a more complete explanation of the application of the accumulated earnings tax in the subsidiary setting, see *supra* notes 83–93 and accompanying text.

policy.²⁹² A purpose of the accumulated earnings tax is to provide a backstop to the shareholder-level tax by forcing the payment of dividends.²⁹³ This purpose is certainly relevant in the context of a U.S. subsidiary of a foreign corporation, regardless of who owns the foreign parent; without potential liability under the accumulated earnings tax, the U.S. subsidiary may have little incentive to pay out dividends, especially since earnings can usually be repatriated tax-free to the foreign parent on the liquidation of the subsidiary.²⁹⁴ Indeed, several commentators appear to be of the view that the accumulated earnings tax is fully applicable in the context of a wholly owned U.S. subsidiary of a foreign corporation, presumably because of the purpose of the tax.²⁹⁵ Moreover, the current rule produces seemingly arbitrary results, in that a U.S. subsidiary owned directly by foreign individuals would have potential liability under accumulated earnings tax.²⁹⁶ There appears to be no sensible reason for protecting the dividend tax in this case but not where the shareholder is a foreign corporation, especially given that the dividend tax rate under the Code would typically be the same in both situations.²⁹⁷

²⁹² Treasury may not have intended this result in originally crafting Treas. Reg. § 1.532-1(a)(1). Because a corporate shareholder would generally be entitled to a dividends-received deduction with respect to distributed earnings, the accumulated earnings tax has traditionally focused on avoidance of the dividend tax with respect to individual shareholders. See BITTKER & EUSTICE, *supra* note 91, at 7-6. Accordingly, the regulations refer to the purpose of avoiding the imposition of the individual income tax on shareholders. However, because a foreign corporation receiving a dividend would generally not be entitled to a dividends-received deduction, requiring a purpose to avoid the individual income tax seems inappropriate in the context of a foreign shareholder. Treasury may simply have overlooked this situation when originally writing the regulation. Nevertheless, Treasury could have amended the regulation to cover a U.S. subsidiary of a foreign corporation; indeed, Treasury did propose such an amendment, but it was subsequently withdrawn. See *infra* note 298.

²⁹³ See 2 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION, C3-22 to -23 (2005); STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 648 (6th ed. 2005).

²⁹⁴ See *supra* note 146 and accompanying text.

²⁹⁵ See Brown, *supra* note 4, at 158 n.141; Feingold & Berg, *supra* note 46, at 219-20; AMERICAN LAW INSTITUTE, *supra* note 21, at 162, 164; KUNTZ & PERONI, *supra* note 293, at C3-22 to -23.

²⁹⁶ Cf. AMERICAN LAW INSTITUTE, *supra* note 21, at 164 (stating that it is appropriate to apply the accumulated earnings tax to a U.S. subsidiary of a foreign corporation, because the withholding tax borne by the parent on dividends from the subsidiary may be regarded as a surrogate for the individual shareholder tax that would have been imposed if the individual shareholders had directly owned the U.S. corporation).

²⁹⁷ For both nonresident aliens and foreign corporations, the Code generally

It may be appropriate then to modify the accumulated earnings tax so that it potentially applies in all cases involving U.S. subsidiaries of foreign corporations. To this end, Treasury apparently could revise the regulations to provide that a purpose to avoid the section 881 tax would also trigger the imposition of the accumulated earnings tax, or Congress could amend the statute to so provide.²⁹⁸ If this were to occur, a U.S. subsidiary of a foreign corporation would very likely be subject to an accumulated earnings tax liability if it retained earnings beyond the reasonable needs of its business.²⁹⁹

2. Promoting Neutrality

With this modification to accumulated earnings tax, differences would still exist in the abilities of U.S. branches and U.S. subsidiaries to control the timing and impact of second-level taxes, with no changes to the branch profits tax other than those recommended with respect to the liability reduction election. Aside from reducing its U.S. liabilities, a foreign corporation could avoid a branch profits tax on its U.S. branch earnings to the extent that it invested the earnings in U.S. assets.³⁰⁰ In contrast, a similarly situated U.S. subsidiary could

imposes a thirty percent withholding tax with respect to dividends received from a U.S. corporation. See I.R.C. §§ 871(a)(1), 881(a), 1441(a), 1442(a), 861(a)(2); *supra* note 26 and accompanying text. A full or partial exemption from the withholding tax applies to dividends from U.S. corporations with substantial foreign business activities. See I.R.C. §§ 871(i)(2)(B), 881(d), 861(c), 1441(c)(10), 1442(a). In very limited circumstances, dividends received by foreign persons may be treated as effectively connected income, in which case the applicable tax rates would be based on the graduated rates under sections 1 and 11, and a foreign corporate recipient would generally be entitled to a dividends-received deduction. See I.R.C. §§ 864(c)(2), 871(b), 882(a), 882(c), 243(a); Treas. Reg. § 1.864-4(c)(2), (c)(3), (c)(5) (2005); *supra* note 116 and accompanying text.

²⁹⁸ Indeed, Treasury once proposed an amendment to the regulations that would have provided for this treatment, although it ultimately withdrew the proposed amendment without explanation. See Prop. Treas. Reg. § 1.532-1(a)(1), 45 Fed. Reg. 84,088 (Dec. 22, 1980), *withdrawn*, 48 Fed. Reg. 25,228 (June 6, 1983). Treasury would appear to have the authority to amend the regulation in this manner; the statute does not expressly limit the purpose to the avoidance of the individual tax, although such a limitation may be implied by the statutory language. See I.R.C. § 532(a) (“purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation”).

²⁹⁹ See I.R.C. § 533(a).

³⁰⁰ See *supra* notes 101–20 and accompanying text. As noted earlier, while it appears very unlikely that foreign corporations conducting U.S. banking businesses would exhaust their ability to use the expanded liability reduction election, foreign corporations conducting nonbanking activities in the United States may well be

avoid a dividend tax as well as an accumulated earnings tax by investing its earnings in assets that are held to meet the reasonable needs of its U.S. business.³⁰¹

With these different standards, it is not clear which structure affords greater flexibility in retaining earnings, the determination being dependent on an interpretation of the rules and the particular facts. For example, with regard to U.S. branches not engaged in a banking business, investment-type assets generally need to be held to meet the present needs of the U.S. business in order to be effectively connected assets.³⁰² Under this rule, a U.S. branch would have less flexibility in retaining earnings than a similarly situated U.S. subsidiary, which could hold investment assets for future U.S. business needs and avoid a second-level tax.³⁰³ However, the rules applicable to nonbanking branches also provide for a presumption of effectively connected treatment where an asset was acquired with funds generated by that business, the income from the asset is reinvested or retained in that business, and U.S. branch personnel significantly managed and controlled the investment of the asset.³⁰⁴ It is unclear whether the Service can rebut the presumption by demonstrating that the asset is not held to meet the present needs of the U.S. business.³⁰⁵ If so, then a U.S. subsidiary would appear to have greater flexibility in retaining earnings, as it could hold assets for future U.S. business needs and avoid a second-level tax. If the presumption is not rebuttable by the Service, a U.S. branch qualifying for the presumption may have the greater flexibility, given that it may be able to hold assets (excluding stock generally) without regard to business need and avoid a branch profits tax.³⁰⁶

limited in their ability to accumulate earnings pursuant to the election. *See supra* note 225.

³⁰¹ *See generally* I.R.C. §§ 531–533; *infra* note 311. The accumulated earnings tax generally allows a corporation to retain during its lifetime a minimum of \$250,000 of earnings without regard to business need (which is referred to as the minimum accumulated earnings credit). *See* I.R.C. § 535(c)(2).

³⁰² *See supra* notes 113–14 and accompanying text.

³⁰³ *See infra* note 311; Musher, *supra* note 45, at 112–13 (pointing out that foreign corporations operating through U.S. subsidiaries have greater flexibility to accumulate earnings for future needs than do those operating through U.S. branches that are apparently subject to the branch profits tax when they accumulate earnings for future needs).

³⁰⁴ *See supra* note 115.

³⁰⁵ *See supra* notes 132–33 and accompanying text.

³⁰⁶ The foreign corporation would still need to satisfy the other requirements of the presumption rule for the assets to be effectively connected; in particular, the

For U.S. banking branches and subsidiaries, their relative flexibility in retaining earnings would depend on the particular facts. Under the special banking rules, a U.S. banking branch can effectively connect a limited amount of certain investment securities, typically long-term corporate bonds and municipal government bonds, as well as an unlimited amount of other securities such as short-term corporate bonds and U.S. government bonds; U.S. banking branches can do so whether or not the securities are held for present or future business needs.³⁰⁷ Consequently, for accumulations in securities consisting of long-term corporate or municipal bonds beyond a U.S. branch's investment securities limit, a U.S. subsidiary may have the greater flexibility, as it would be able to retain earnings in these types of securities if it has a reasonable business need.³⁰⁸ In contrast, a U.S. branch could not do so even with such a need. Nevertheless, a U.S. branch could retain earnings in short-term corporate and U.S. government bonds without regard to any tax limitations. For accumulations up to the investment securities limit (and greater than the minimum accumulated earnings credit³⁰⁹), the U.S. branch would have the greater flexibility, as it could retain earnings in any of these securities regardless of need, whereas a U.S. subsidiary could only do so if it has a reasonable business need for the accumulation.³¹⁰

To make the application of the branch profits and dividend taxes more equivalent, U.S. branches and U.S. subsidiaries should have a similar ability to retain U.S. earnings while avoiding a second-level tax. Accordingly, with the above-described change to the accumulated earnings tax, a foreign corporation with a U.S. branch should be permitted an election to treat investment assets producing U.S. source income as being effectively connected, provided the assets are held to meet the reasonable needs of the foreign corporation's U.S. business.³¹¹ For this purpose, the reasonable business needs

income from the assets would need to be reinvested or retained in the U.S. business. See *supra* notes 129–30 and accompanying text.

³⁰⁷ See *supra* notes 135–38 and accompanying text.

³⁰⁸ See I.R.S. Tech. Adv. Mem. 98-22-009 (May 29, 1998) (applying the accumulated earnings tax to a bank, and examining the bank's business need for retaining earnings in liquid assets such as cash, cash deposits with the federal reserve system, and taxable and tax-exempt securities).

³⁰⁹ See *supra* note 301.

³¹⁰ Cf. I.R.S. Tech. Adv. Mem. 98-22-009 (May 29, 1998).

³¹¹ Cf. Feingold & Berg, *supra* note 46, at 220 (appearing to recommend an election to treat assets as effectively connected to the extent of the amount of reasonable future anticipated needs of the foreign corporation's U.S. business; apparently calling for an interest charge on certain portions of the branch profits tax

standard should be the same as under the accumulated earnings tax.³¹²

liability that are deferred as a result of such treatment).

If elected assets are not held for the reasonable needs of the business conducted by the U.S. branch, the assets would be disqualified for effectively connected treatment for purposes of the branch profits tax. However, it would appear that the assets should still be considered as generating effectively connected income for regular tax purposes. This would be consistent with an application of the accumulated earnings tax in the context of a U.S. subsidiary, where earnings subject to the penalty tax continue to remain in corporate solution, and thereby generate income subject to net basis taxation by the United States (if invested in income-producing assets). In a similar vein, modifications to the workings of the branch profits tax may be appropriate given that the accumulated earnings tax can function as a third level of taxation. See James C. Warner & Lauren T. Byrne, *Accumulated Earnings Tax*, 796-2nd T.M. (BNA) at A-1. That is, following the imposition of the accumulated earnings tax on a corporation's retained earnings, a shareholder level tax would normally be imposed on these earnings when they are ultimately distributed to the corporation's shareholders (either in the nonliquidating or liquidating context). Nevertheless, a third level of tax is mitigated somewhat in the case of a U.S. subsidiary of a foreign corporation, given that a liquidating distribution generally would not be subject to a shareholder level tax. See *supra* note 146 and accompanying text. Therefore, there may not be a strong need to modify the branch profits tax in order to achieve parity with the application of the accumulated earnings and shareholder level taxes in the subsidiary setting. If modifications were to occur, I suggest that solely for purposes of reducing accumulated effectively connected E&P by the dividend equivalent amount for the year of the asset election, see Treas. Reg. § 1.884-1(b)(3)(ii) (1996), the dividend equivalent amount should exclude the amount of disqualified elected assets; as a result, the amount of disqualified elected assets would not be removed from accumulated effectively connected E&P. This would be similar to the application of the accumulated earnings tax, where retained earnings subject to the penalty tax are not removed from E&P. I also suggest that assets that are disqualified for the year of the election nevertheless be treated as U.S. assets for determining dividend equivalent amounts for subsequent years (regardless of whether the assets are held for the reasonable needs of the U.S. business). This would be consistent with not reducing accumulated effectively connected E&P by the amount of disqualified assets, and would result in a third level of tax (pursuant to the branch profits tax) if the elected assets were subsequently sold and the proceeds were invested in assets beyond the scope of net basis U.S. taxation, similar to a U.S. subsidiary's nonliquidating distribution of earnings previously subject to the accumulated earnings tax.

³¹² See, e.g., Treas. Reg. § 1.537-1, -2 (1986). In this regard, the regulations include the following grounds, if supported by sufficient facts, as possibly satisfying the reasonable business needs standard: (i) providing for business expansion or plant replacement, (ii) acquiring a business enterprise, (iii) providing for the retirement of indebtedness created in connection with the business, (iv) providing for necessary working capital for the business, (v) providing for investments or loans to suppliers or customers if needed to maintain the business, and (vi) providing for the payment of reasonably anticipated product liability losses. See Treas. Reg. § 1.537-2(b) (1986). Given the number of foreign corporations that conduct banking or insurance

In addition, similar to the minimum accumulated earnings credit,³¹³ a foreign corporation with a U.S. branch generally should be permitted to elect during its existence at least \$250,000 of U.S. source assets as being effectively connected, regardless of whether the assets are held for the reasonable needs of the U.S. business.³¹⁴ To ensure that U.S. branches would not have greater flexibility than U.S. subsidiaries in retaining earnings, the presumption rule should be eliminated (at least for foreign corporations), since this provision may not require a business need in order to effectively connect assets.³¹⁵ Also, consideration should be given to eliminating the ability of U.S. banking branches to effectively connect investment securities that have no relationship to the U.S. business (other than participation by U.S. branch personnel in arranging for the acquisition of the securities).³¹⁶ This elimination should be considered despite the administrative benefits of the current rule, which does not require a

businesses through U.S. branches, *see supra* note 205, it may be wise for Treasury and the Service to issue regulations or rulings specifically applying the reasonable business needs standard to these situations. In this regard, I.R.S. Tech. Adv. Mem. 98-22-009, *supra* note 308, applies the accumulated earnings tax to a bank, and in doing so examines reasonable business needs in this context, such as the need to maintain sufficient capital to satisfy Federal Reserve requirements, along with other grounds for reasonable accumulations that are set forth in Treas. Reg. § 1.537-2(b).

³¹³ *See supra* note 301.

³¹⁴ *Cf.* Feingold & Berg, *supra* note 46, at 220 (appearing to recommend an election to treat assets as effectively connected to the extent of the amount of reasonable future anticipated needs of the foreign corporation's U.S. business, or minimum amount, if greater, with such minimum amount possibly equal to the minimum accumulated earnings credit under the accumulated earnings tax). The minimum accumulated earnings credit is reduced to \$150,000 for corporations whose principal function is performing services in the field of law, accounting, consulting, actuarial science, health, engineering, architecture, or performing arts. *See* I.R.C. § 535(c)(2). Similarly, for U.S. branches performing such services, the minimum amount of assets that can be elected as effectively connected should be reduced to \$150,000.

³¹⁵ *See supra* notes 305–06 and accompanying text. With the elimination of the presumption rule, there is the possibility that a foreign corporation could avoid U.S. net basis taxation on certain income that was previously covered — for example, interest income satisfying the presumption requirements where the foreign corporation cannot demonstrate that the underlying asset was not held for present U.S. business needs. *See supra* notes 128–33 and accompanying text. Nevertheless, because a foreign corporation typically could avoid the presumption rule if it so desires by failing intentionally one of its requirements, eliminating the presumption rule should not create a material advantage for taxpayers wanting to avoid effectively connected treatment.

³¹⁶ *See supra* notes 307–10 and accompanying text.

determination of a business need for holding the securities.³¹⁷

Like the primary proposal, the alternative proposal to expand the definition of effectively connected assets would no more result in the effective repeal of the branch profits tax than the ability of a subsidiary to accumulate earnings results in the effective repeal of the dividend tax. With the alternative proposal (as well as the primary proposal), the branch profits tax would continue to affect the U.S. tax liability of foreign corporations' U.S. branch operations, in that the election to effectively connect assets would likely also produce a cost by subjecting the income from the affected assets to U.S. net basis

³¹⁷ In this regard, the concept of the investment securities rule, allowing a certain percentage of U.S. banking branch assets to consist of investment securities, may be consistent with an application of a reasonable business needs standard to a banking branch, given the need to satisfy reserve or similar requirements (although the special banking rules do contain a provision that can allow for the effectively connected treatment of stocks or securities held for the purpose of satisfying reserve requirements established by United States banking authorities. See Treas. Reg. § 1.864-4(c)(5)(ii)(a)(3) (2005)); cf. I.R.S. Tech. Adv. Mem. 98-22-009, *supra* note 308 (discussing the maintenance of adequate capital to satisfy Federal Reserve requirements as a reasonable business need for banks); Rubinstein & Yu, *supra* note 152, at 67-68 (referring to securities treated as effectively connected under the investment securities rule as used to satisfy reserve or similar requirements). Accordingly, a modification of the investment securities rule may be appropriate in order to approximate a reasonable business needs determinant if the current rule does not adequately do so. Aside from the presumption rule and the ability of banking branches to effectively connect investment securities, the effectively connected rules appear to be consistent with the reasonable business needs standard under the accumulated earnings tax, as these rules require that assets either be held for present business needs (in the case of the asset-use test) or directly relate to the operation of the U.S. business (in the case of the business activities test, special banking rules with regard to loans, or foreign effectively connected rules). See *supra* notes 103-38 and accompanying text. See generally Treas. Reg. §§ 1.864-4 (2005), 1.864-5 (1997), 1.864-6 (1972).

As noted earlier, some consideration should be given to excluding foreign banks from having the election to effectively connect investment assets. See *supra* note 234. Nevertheless, under this alternative proposal for an effectively connected election, it may be appropriate to include foreign banks even if that is not the case under the primary proposal. This is because the alternative proposal also may call for the elimination of the ability of foreign banks to effectively connect investment securities having no relationship to the U.S. business (as discussed above). Thus, this proposal may result in limiting a U.S. banking branch's ability to retain earnings. Consequently, the alternative proposal arguably should apply to U.S. banking branches so that they do not have more flexibility in retaining earnings than do similarly situated U.S. subsidiaries, even though in both cases second-level taxes may be avoidable by reducing liabilities that are taken into account for U.S. tax purposes.

taxation.³¹⁸ Moreover, as compared to the primary proposal, a foreign corporation would have less ability to eliminate its liability under the branch profits tax by electing to treat a sufficient amount of assets as being effectively connected, because of the requirement that the assets be held for the reasonable needs of the U.S. business.³¹⁹

3. Potential Policy Conflicts

The alternative proposal to provide foreign corporations with an election to effectively connect assets gives rise to potential conflicts with recognized policies that are similar both in their type and resolution to those raised by the primary proposal. In this regard, the alternative proposal should not conflict with the policies underlying the effectively connected income rules, especially if stock is not eligible for election.³²⁰ Indeed, because the assets would need to be held for the reasonable needs of the U.S. business in order to be eligible for effectively connected treatment, the alternative proposal may even be consistent with the language of section 864(c)(2)(A), which takes into account whether the assets are used or *held for use* in the conduct of the U.S. business.³²¹

³¹⁸ See *supra* notes 253–59 and accompanying text.

³¹⁹ As with the primary proposal, the alternative proposal also should contain the analogue to the personal holding company tax that is discussed in the text accompanying notes 249–252. As a result, the Service could prevent excessive accumulations of effectively connected E&P by treating elected assets as non-U.S. assets based on either an objective standard (the personal holding company tax analogue) or a subjective standard (the accumulated earnings tax analogue), similar to the application of the penalty taxes in the case of a U.S. subsidiary.

³²⁰ See *supra* notes 272–78 and accompanying text.

³²¹ A “reasonable needs of the U.S. business” standard, which includes assets held for future expansion, may well be consistent with the language of the committee reports. See S. REP. NO. 1707, *supra* note 260, 1966-2 C.B. at 1072 (stating “[t]hus, for example, are the assets held for future, or remittent, use in the business?”); H.R. REP. NO. 1450, *supra* note 130, 1966-2 C.B. at 977 (same). In particular, the House technical explanation focuses on the connection between the asset and the needs of the U.S. business, without limiting this to present needs. While the examples provided are consistent with a present business needs approach, they do not appear to foreclose taking into account future business needs in determining effectively connected status. See H.R. REP. NO. 1450, *supra* note 130, 1966-2 C.B. at 1008-1009. Nevertheless, the regulations reject such an approach, and instead interpret the statute as requiring a present business need in order to effectively connect assets and income under the asset-use test (subject to the presumption rule, which is discussed at *supra* notes 115, 128–33 and accompanying text). See *supra* notes 113–14, 126–27 and accompanying text.

As with the primary proposal, there would be limits on the ability of a foreign corporation to strategically elect effectively connected status for investment assets in order to increase its interest expense deduction under Treas. Reg. § 1.882-5. These would include the possible nonimputation of liabilities on assets affected by the election, an annual cap on the amount of assets eligible for the election (no greater than the amount needed to reduce the dividend equivalent amount to zero), as well as restrictions on the amount of currently deductible interest pursuant to the earnings stripping rule.³²² Moreover, the alternative proposal would contain an additional curb on possible manipulation resulting from the requirement that elected assets be held for the reasonable needs of the foreign corporation's U.S. business.

The alternative proposal would cause greater concerns of administrability as compared to primary proposal. This results from requiring a determination of whether an investment is held to meet the reasonable needs of the foreign corporation's U.S. business. This determination would incorporate the test used under the accumulated earnings tax, which involves somewhat vague standards and potential enforceability difficulties.³²³ Nevertheless, the ability to elect effectively connected status for investment assets should reduce the number of situations where it is necessary to apply the asset-use test and its fact specific standards,³²⁴ which may be equally vague and difficult to apply and enforce.³²⁵ Consequently, the alternative proposal for providing an election to effectively connect assets may result mostly in administrative tradeoffs rather than additional burdens.

V. CONCLUSION

The branch profits tax is founded on the policy of tax neutrality with respect to the form of conducting a business, yet as currently

³²² See *supra* notes 285–89 and accompanying text.

³²³ See Warner & Byrne, *supra* note 311, at A-1 (pointing out that the accumulated earnings tax is rarely imposed on most corporations, and that the Service's failure to recognize situations when the tax applies is due to the complexities of determining the necessary intent to avoid the shareholder level tax, as well as accounting rules and calculations for E&P and reasonable business needs).

³²⁴ This is true because taxpayers desiring effectively connected treatment for investment assets may be electing such treatment under the more liberal reasonable business needs standard, rather than having the determination made under the asset-use test's present business needs standard.

³²⁵ See *supra* note 284.

implemented the provision does not adequately advance this concept. This article proposes several changes to the branch profits tax that both promote neutrality and are consistent with other recognized policies governing the taxation of U.S. branches of foreign corporations. Specifically, I recommend the following reforms: (i) eliminate the potential for recapture upon the termination of a U.S. branch where a foreign corporation elects to reduce its U.S. liabilities, (ii) remove the U.S. booked liability limitation under the election to reduce U.S. liabilities, and (iii) provide foreign corporations with an election to treat investments generating U.S. source income as effectively connected assets.³²⁶ With these changes, foreign corporations with U.S. branches generally would have a choice of whether to incur a second-level tax or instead have (or continue to have) the income on invested earnings taxed by the United States on a net basis. Thus, the branch profits tax would function more like the dividend tax in the U.S. subsidiary setting, thereby promoting the neutrality goals underlying the provision.

³²⁶ Consideration should be given to excluding stock as an asset that is eligible for elective effectively connected treatment. A foreign corporation should not be permitted to elect effectively connected treatment for a greater amount of assets than is necessary to reduce its dividend equivalent amount to zero for a particular year.

The proposal to provide foreign corporations with an election to effectively connect investment assets assumes that there are no changes in applying the accumulated earnings tax to a U.S. subsidiary of a foreign corporation. If a change does occur so that the accumulated earnings tax is potentially applicable in all cases to a wholly owned U.S. subsidiary of a foreign corporation, this article recommends that the election be available only for U.S. source investment assets that are held to meet the reasonable needs of the foreign corporation's U.S. business.

Some consideration should be given to excluding foreign banks under both the primary and alternative proposals for providing an effectively connected election.